S. Hrg. 103-102

THE BREAKDOWN OF IRS TAX ENFORCEMENT REGARDING MULTINATIONAL CORPORATIONS: REVENUE LOSSES, EXCESSIVE LITIGATION, AND UNFAIR BURDENS FOR U.S. PRODUCERS

HEARING

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

MARCH 25, 1993

Printed for the use of the Committee on Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE

66-349 ⇆ WASHINGTON : 1993

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-041126-2

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THE BREAKDOWN OF IRS TAX ENFORCEMENT REGARDING MULTINATIONAL CORPORATIONS: REVENUE LOSSES, EXCESSIVE LITIGATION, AND UNFAIR BURDENS FOR U.S. PRODUCERS

THURSDAY, MARCH 25, 1993

U.S. Senate,
Committee on Governmental Affairs,
Washington, DC.

The Committee met, pursuant to notice, at 1:36 p.m., in room SD-342, Dirksen Senate Office Building, Hon. Byron Dorgan, presiding.

Present: Senators Dorgan and Levin.

OPENING STATEMENT OF SENATOR DORGAN

Senator Dorgan. The hearing will come to order.

This is the Senate Committee on Governmental Affairs and we are pleased that all of you are here at this hearing today.

We apologize very much for the disruption this morning. As you know, the Senate held a long series of votes with no debate, 15 minutes for each vote, and it was simply impossible to hold a hearing at that time. All the hearings, I believe, that were scheduled this morning had to be rescheduled. We appreciate your patience. We will perhaps try to contract this hearing just a bit, because there are some people on the witness list who have airplanes to catch this afternoon.

Having said all that, I would like to make a brief opening statement, and then I would like to call on the witnesses we have with us today.

To see why we were here today, a good place to start would be at the U.S. Tax Court down the street. There in room G-24, you could see the debris from the nation's current multinational tax enforcement system.

One recent case is a good example. It occupies 19 file boxes full of legal and economic arcana that took 10 years and a small fortune to produce. The judge in the case called this sophistry mainly "useless." He needed 4 years to slog through the mess, and his decision came to 240 pages—and that was just one case and one corporation.

What was the point of this monumental paper chase? To argue over the "correct" prices for some spare airplane parts that a U.S. corporation produced in the tax haven of Singapore and shipped back to its U.S. operations. The case resolved only 2 years of taxes,

1978 and 1979, and the government and the taxpayers have to repeat this same exercise in years that are disputed since then.

So welcome to the world of multinational tax enforcement, which the U.S. Treasury has turned into a massive public works program for beltway tax lawyers, accountants and economic consultants, and a major drain on the public purse. Easily, in my judgment, at least $10 billion a year disappears into the dark recesses of this complicated enforcement mess—not even counting the costs of the bureaucracy and litigation.

The U.S. Treasury has taken a modest first step towards a solution, which is in the President's economic plan. But the new IRS regulations will raise well under a billion dollars, and the litigation may well get even worse. Corporations will now have to justify all their internal pricing decisions up front. This will be a potlatche for economic consultants. But it will be a huge burden for honest business taxpayers, and it won't bring us much closer to a solution.

We have to find a better way, and that is the purpose of this hearing. The Federal Government simply cannot afford all this bureaucracy and litigation, and neither can the corporate taxpayers.

Fundamental questions of tax justice are at stake as well. The individuals and small businesses of this country have demonstrated they are willing to do their share. They have responded to President Clinton's proposal with a public spirit that has defied many of the pundits. Now we have to ask multinational corporations that do so well in our market to pay their fair share of taxes, too.

If America raises corporate tax rates, without a radical reform of our multinational enforcement, then America's smaller businesses and home-grown producers will end up paying the bill, while the multinational giants continue to contribute little or nothing.

This is not mere polemics. The tax avoidance by multinational firms, and especially foreign-based firms, is epidemic. As the GAO will testify today, some 72 percent of foreign based corporations that do business here pay no Federal income taxes. These are not just obscure import-export firms, either. We are talking about some of the largest corporations in the world, including foreign auto and electronics makers that are household names, they do business in our country, earn money in our country, but pay no Federal income taxes in our country.

Under Representative Jake Pickle, the House Ways and Means Subcommittee on Oversight identified one foreign auto maker, for example, that sold $3.4 billion worth of cars here in 2 years and paid no Federal income taxes—not a penny. Now, how do we justify that to individual taxpayers and Main Street businesses that are digging into their bank accounts in order to satisfy their April 15th obligation?

The answer is we cannot justify it, because it simply is not fair. The IRS is actually helping these foreign firms to compete against U.S. firms, by giving them tax breaks through a hapless enforcement system. Is it any wonder that Treasury has consistently played down the lost revenue and has tried to keep the whole issue under wraps?

The problem has festered at the IRS for decades, and only the explosion in world trade has forced it into the open. How do you distinguish between a corporation's U.S. income from the income

that should be reported elsewhere? That sounds simple, but it is not. The fact is the States had to grapple with that problem early on and have come up with a solution that I think makes a lot of sense.

I was involved in tax administration in one State, and was Chairman of an organization called the Multistate Tax Commission that brought together many States, in a cooperative enforcement effort. We developed a formula which resulted in a fair apportionment of a corporations income among the various States in which it did business.

That is precisely the approach the Federal Government ought to take. There's a new and workable way for corporations to report their income for tax purposes—one that is simpler for them and that eliminates bureaucracy, and that most importantly, results in a fair tax burden for those who are doing business in this country.

I am going to insert the rest of my statement in the record today.

Opening Statement of Senator Dorgan

To see why we are here this morning, a good place to start is at the U.S. Tax Court down the street. There, in room G–24, you can see the debris from the nation's current multinational tax enforcement system.

One recent case is a good example. It occupies 19 file boxes full of legal and economic arcana that took ten years and a small fortune to produce. The judge in the case called this sophistry mainly "useless." He needed four years to slog through the mess; his decision came to 240 pages.

What was the point of this monumental paper chase? To argue over the "correct" prices for some spare airplane parts, that a U.S. corporation produced in the tax haven of Singapore, and shipped back its U.S. operations. The case resolved only two tax years, 1978–79, moreover. The government and the taxpayer have to repeat this insane exercise for the disputed years since then.

Welcome to the world of multinational tax enforcement, which the U.S. Treasury has turned into a massive public works program for Beltway tax lawyers, accountants and economic consultants, and a major drain on the public purse. Easily, at least $10 billion a year disappears into the dark recesses of the compliance mess—not even counting the costs of bureaucracy and litigation.

The Treasury has taken a modest first step towards a solution, in the President's economic plan. But the new IRS regulations will raise well under a billion dollars, and the litigation may well get worse. Corporations will now have to justify all their internal pricing decisions up front. This will be a potlache for economic consultants. But it will be a huge burden for honest taxpayers, and it won't bring us much closer to a solution.

We have to find a better way. The Federal Government can't afford all this bureaucracy and litigation, and corporate taxpayers can't either.

Fundamental questions of justice are at stake. The individuals and small businesses of this country have shown that they are willing to do their share. They have responded to President Clinton's call with a public spirit that has defied the pundits and flumoxed those who think the sole purpose of government is to cater to greed.

Now we have to ask the multinational corporations that do so well in our market, to pay their share too.

If America raises corporate tax rates, without a radical reform of our multinational enforcement, then America's smaller businesses and home-grown producers will end up paying the bill, while the multinational giants continue to contribute little or nothing.

This is not mere polemics. Tax avoidance by multinational firms—and especially foreign based firms—is epidemic. As the General Accounting Office will testify this morning, some 72 percent of the foreign-based corporations that do business here, pay no Federal income taxes. These aren't just obscure import-export firms, either. We are talking about some of the largest corporations in the world, including the foreign auto and electronics makers that are household names.

Under Rep. Jake Pickle, the House Ways and Means Oversight Subcommittee identified one foreign automaker—fairly typical, it turned out—that sold $3.4 billion worth of cars here over two years, and paid no Federal income tax. Not a penny.

How do we justify that to our individual taxpayers and Main Street businesses that are now digging into their bank accounts to pay the taxes that are due on April 15th?

We can't justify it, because it simply is not fair. The IRS actually is helping these foreign firms to compete against U.S. firms, by giving them under-the-table tax breaks through hapless enforcement policies. Is it any wonder that the Treasury has consistently played down the lost revenue, and has tried to keep the whole issue under wraps?

The problem has festered at the IRS for decades, and only the explosion in world trade has forced it into the open. How to distinguish a corporation's U.S. income, from the income that should be reported elsewhere? It sounds simple, but it isn't. A global enterprise such as Sony, say, operates through a multitude of subsidiaries throughout the world. All kinds of products and services flow back and forth within the corporation's worldwide web: patents, parts, shared overhead, finished products, and a zillion other things.

By putting "prices" on these transfers, the company can easily shift its income off its U.S. books and into the black holes in its international balance sheets. And that's what happens.

The way the IRS tries to uncover these shell games is straight out of the Keystone Kops. It is the most lawyer-intensive system one can imagine. The agency dispatches auditors to comb through a corporation's millions of internal transactions—one by one—and try to adjust the prices to a hypothetical market level. Usually such a market price does not exist, because the transactions are unique to the particular corporation. So the auditor has to make one up.

This is the bureaucratic equivalent of trying to empty the ocean with a teaspoon. The IRS is overwhelmed, and big corporations know it. The result is a legalistic quagmire in which the corporation usually ends up on top. The GAO will testify today that in a recent year, only 5% of our auditor's assessments on foreign-based firms were ultimately sustained. Meanwhile, medieval disputes over "correct" prices are clogging the tax court at an increasing rate.

Frances Zuniga, a former IRS examiner, says in written testimony that "no one can really determine an arms length price." Even the Wall Street Journal suggested (while misstating the underlying issue) that the Treasury's enforcement approach is "impossible."

What makes this situation truly strange, is that a remedy is at hand. Long ago, the states had to come to grips with corporations operating freely across their borders. They knew they couldn't possibly disentangle the spaghetti pile of a larger corporation's internal accounting. So they devised a simple formula to do the job instead. This formula approach works. The U.S. Supreme Court has upheld it continually as reasonable and fair. Today, we can apply that basic approach to corporations operating across national borders as well, as some states do already.

The formula approach would ease compliance burdens on honest taxpayers. It would flush out the billions of dollars that currently disappear into the enforcement morass. Better still, the formula approach would render the medieval accounting games irrelevant; corporations could focus on business instead of fancy tax strategies, and the government could save money.

No wonder the cries of protest on K Street. Transfer pricing schemes have become a major industry in this town. This one tax avoidance niche is now so lucrative, that the Bureau of National Affairs publishes a special "Transfer Pricing" newsletter that goes for $895/yr. Lawrence Summers, the administration's nominee to be Treasury undersecretary for international affairs, recently called the current system a "full employment act for tax attorneys."

This is a growth industry that America can do without. The IRS can change without any new laws, moreover. It has all the authority it needs under laws already on the books.

Critics say that the formula method would result in "double taxation," by grabbing income that ought to be reported elsewhere. But there's a long way to go before we get even to single taxation. Besides, regulations could easily guard against any double taxation that might occur.

Critics also say that our tax treaties prohibit the use of the formula method. But this morning we will hear a contrary view. The purpose of those tax treaties, after all, is to promote tax enforcement, not frustrate it.

There's a game going on here. Lobbyists for multinational firms have helped keep the IRS mired in a rut. Then they go abroad and say, "See, the U.S. is using the 'arms-length' method, so you should use it too." Then they come back to the U.S. and say, in effect, "Now you can't change because your trading partners are using this antiquated system too."

The fact is, the U.S. is the world leader in this area. Other countries generally take their enforcement cues from us. To wait for a better world climate is to wait, in effect, for ourselves. Already, the European Community is actively exploring the formula method to harmonize the tax laws of the members nations.

The upshot is this. Our tax court is jammed. The IRS bureaucracy is bulging and overloaded. Honest corporate taxpayers face growing compliance burdens. And some of the largest corporations are not paying their fair share. That sounds an awful lot like a description of a system that needs fundamental change.

Questions and Answers Regarding the Breakdown of Multinational Tax Enforcement and How to Reform It

Question. Why Has Multinational Tax Enforcement Become Such a Big Problem?

Answer. Put very simply, it's because international commerce has outgrown the IRS enforcement system. The problem is deciding what goes where; that is, determining how much of a company's income should be reported in the U.S., as opposed to other countries. The Federal Government is going into the 21st Century with 19th Century accounting principles, and the system is breaking down.

Question. What Makes The Task So Difficult?

Answer. The way a multinational corporation can shift its taxable income just about anyplace it wants, through complex accounting games.

What we know as "Sony," say, is on paper a multitude of separate corporate entities located in countries throughout the world. These share overhead and management, transfer parts and technology from one to another, and basically operate as parts of a global business unit.

But the IRS treats these subsidiaries as entirely separate and unrelated. This enables the company's accountants—the "tax planners"—to shift income out of the U.S. by tinkering with the "prices" they put on the transfers within the corporation's worldwide web. Often, this income gets reported nowhere, giving rise to what auditors call "Nowhere income."

Question. So What?

Answer. First off, the tax avoidance gives foreign-based firms, and big multinationals generally, a big advantage over our own producers that are struggling to keep their jobs here in the U.S.

Second, this tax avoidance costs American taxpayers over $10 billion a year in lost revenue. According to the General Accounting Office, some 72 percent of foreign-based corporations doing business here pay no Federal income tax at all. This means they get our defense umbrella and other important services absolutely free.

Finally, the IRS's antique enforcement approach has given rise to a bureaucracy that grows bigger by the year, with no end in sight. It has clogged the tax court with expensive and pointless litigation, and imposed unnecessary burdens on honest taxpayers.

Question. So Are You Proposing A New Tax?

Answer. No—and not a higher tax rate either.

Rather, we're proposing a simpler and more modern way to enforce the laws already on the books—a way that will reduce tax avoidance, compliance costs for taxpayers, and also litigation. Foreign based corporations and other big multinational concerns should pay the same taxes that our U.S. businesses have to pay, and there's a way to make that happen.

Question. What Exactly Does the IRS Do Now?

Answer. As mentioned, the IRS starts with a fiction: That the subsidiaries of a global corporation have no special relationship to one another, but rather deal at "arms length." Accordingly, the agency dispatches its auditors to comb through all the millions of transactions within these worldwide corporate networks. The auditors try to adjust the prices to what they would be if the parties really were dealing at arms length—which they are not and have no business reason for doing.

Question. That Sounds Like A Lot of Work?

Answer. It's an enormous amount of work. Audits take thousands of hours. Usually, there are no comparable market transactions to use as a guide, so auditors have to resort to arcane economic theories to come up with plausible numbers. This vague standard produces the worst kind of game-playing (by corporate taxpayers and IRS alike), and produces as well the medieval legal squabbles that often take over 10 years—and a small fortune—to resolve. "The fact is," a former IRS auditor has said, "no one can really determine an arms length price."

In the end, the IRS and taxpayers alike must expend vast resources simply to maintain an economic fiction. "The only winners under Treasury's current arms-

length pricing approach," writes Dale Wickham, a Washington tax attorney and law professor who served on the staff of the Congressional Joint Tax Committee, "are the many professional middlemen—accountants, tax auditors, lawyers, economists, valuation experts, technical information publishers, and other professionals."

Question. But Doesn't the IRS Have New Regulations That Will Simplify Things?

Answer. There are new regulations that will shift the burden to corporations to justify their internal pricing policies when they set them. This will narrow the problem in some ways, but enlarge it in others, because the IRS will now have to wrestle with the sophisticated economic theories that the companies' economists will produce. Also, the honest companies now face yet another compliance burden, because they have to produce these theoretical exercises.

Question. So What Do You Propose?

Answer. A simple formula approach that would render irrelevant the accounting gymnastics and tax lawyering that thrive under the current system.

Question. Where Does That Idea Come From?

Answer. The States. For decades, the States have had to deal with the problem the Federal Government is facing now: How to apportion the income of corporations that operate freely across jurisdictional borders. Unlike the Federal Government, the States have to balance their budgets; they needed a system that was efficient and lean. So they adopted the formula approach.

This method was first applied to railroads and other utilities operating across State lines. Step by step, the States applied it to other corporations as well. Some have used it in the multinational arena. The Supreme Court has upheld the approach continually as reasonable and fair.

Question. How Does The Formula Method Work?

Answer. It is based on the premise that the parts of an integrated multinational corporation work together towards a single bottom line. Therefore, the company should report its income in proportion to the business in does in a particular State or nation—no more and no less. The most common formula is based on three factors: Property, payroll and sales. If a company does, say, one-thirtieth of its business in a particular country as measured by these factors, it would report one-thirtieth of its income there too.

Naturally, this basic formula can be adjusted to the peculiarities of international commerce.

Question. Is This A Tax Increase?

Answer. No. Some corporations actually would pay less under the formula approach. But tax avoidance would go down and revenues would increase, because the system has fewer complexities and hiding places. The tax law would have something it doesn't have now: A relatively clear and predictable standard for multinational concerns. That's why a growing number of tax authorities are advocating this step. Charles E. McClure, Jr., a tax official in the Reagan administration, wrote that the Treasury approach "cannot satisfactorily divide the income of a unitary business."

Question. But Wouldn't This Formula Method Distort A Company Income?

Answer. No. Distortion happens now, under the current IRS method, which is why there's so much litigation and lost revenue. Corporate taxpayers are thronging to the tax court in increasing numbers to appeal the agency's assessments. At last count there was some $32 billion at issue in pending tax court cases alone, not even counting the cases in the agency's appeals pipeline. "The arms-length standard is impossibity vague," says David Rosenbloom, a tax attorney with Caplin and Drysdale and a former Treasury official.

Under the formula method there would be less distortion than exists now. Opponents often cite the problem of start-up costs. Generally, it takes a few years for a new factory to start to turn a profit. Yet under the formula method, they claim, the factory weighs into the formula right away, thus making more income taxable in the U.S.

In the first place, such quirks often balance out over time. But if necessary, the formula can easily be adjusted to give less weight to new investment in the early years.

Question. What About The "Double Taxation" Argument?

Answer. Opp9onants also claim that the formula method would make multinationals more vulnerable to taxes on the same income in more than one country. In other words, they say, the U.S. would be more likely to tax income that is already taxed someplace else.

That's not true. It sounds plausible in theory; but in practice it happens rarely if ever. No one takes all of a multinational's tax returns and lays them down side by side. But if they did, they'd find billions of dollars that fall through the cracks in the world's tax systems.

Until we have single taxation, we should not worry too much about double taxation. It would not be hard to construct safeguards against that possibility. Tax experts agree that in the long run, the formula method offers more hope for uniformity between tax systems than anything the Treasury is doing now.

Question. Fair Enough. But Can the U.S. Do This Under Its Tax Treaties With Other Nations?

Answer. Yes. Nothing is existing treaties stops the IRS from using a formula approach, especially when the "arms length" method doesn't work, as it doesn't in the majority of cases. The purpose of these tax treaties, after all, is to assist enforcement, not frustrate it.

A number of respected tax authorities say that formula apportionment could be defended successfully as a way to implement the arms length standard, should a tax treaty partner raise such a challenge. But a goodly number of those nations have acknowledged that the formula approach is appropriate in at least some circumstances: The OECD, the UK's Inland Revenue, and the tax agencies of France and Germany. In fact, the European Community is actively considering the formula method as a way to harmonize the corporate tax systems of its individual members.

We need to remember that the United States is the world leader in this field. Other nations take their cues from us; and to the extent they follow the arms length standard, it's because the U.S. has done it too. Corporate tax lobbyists are trying to tie Congress up in a tautology. They say the U.S. should use an antiquated, lawyer-intensive enforcement method because other countries do. Then they tell those countries they should follow it because the U.S. does.

Question. Are You Saying The Formula Approach Is Perfect?

Answer. Not at all. Multinational corporations are sprawling, complex organizations, and any kind of tax involves difficulties. But the formula approach is simpler than what the IRS does now. It involves less difficulty and makes sure that big multinational firms pay their share.

One problem under the formula approach, for example, is to define the integrated, or "unitary" business. A multinational might own a subsidiary that is so isolated and distinct from the rest of the company's business that it should be taxed separately and not included in the formula. Another problem is the need to translate the foreign "book" income into U.S. accounting standards, so that the formula won't be distorted.

States like California have been able to deal with such problems, with much leaner bureaucracies than the Federal IRS. They have 75 years experience in defining unitary businesses, and have done so to the satisfaction of the U.S. Supreme Court. They've also worked out ways to handle foreign accounting systems; and anyway, this problem is diminishing through the efforts of the International Federation of Accountants.

"Of course the formula method will not yield perfect results in all instances," says Michael J. McIntyre, professor of law at Wayne State University, "But (it) will produce consistent, fair outcomes—a far cry from the current arms-length system."

Senator DORGAN. I am going to ask that we begin with Mr. Gandhi, Associate Director of Tax Policy and Administration Issues, at the U.S. GAO.

Mr. Gandhi, I have read your statement and I would appreciate it if you would summarize for us today the statement that you are offering, and then we would like you to be available for questions.

Mr. Gandhi, you may proceed.

TESTIMONY OF NATWAR M. GANDHI,[1] ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, U.S. GOVERNMENT ACCOUNTING OFFICE; ACCOMPANIED BY JOSE OYOLA, ASSISTANT DIRECTOR, INTERNATIONAL TAXATION, LARRY KORB AND KEVIN DALY, TRANSFER PRICING

Mr. GANDHI. Thank you, Mr. Chairman.

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[1] The prepared statement of Mr. Gandhi appears on page 45.

Mr. Chairman and members of the Committee, last year, we issued a report on transfer pricing issues. We are pleased to be here today to provide you with some updated information.

Joining me here are three of my colleagues. On my left is Jose Oyola, Assistant Director in charge of our international tax work, and on my right are Larry Korb and Kevin Daly, who have been involved with our transfer pricing project.

Mr. Chairman, today we will make four major points. First, a review of 1989 and 1990 tax data showed that, as in previous years, a larger percentage of foreign controlled corporations than U.S. corporations paid no U.S. income tax.

Second, IRS' experience in dealing with transfer pricing issues has continued to be difficult and dollar amounts at stake have remained in the billions. IRS examiners have increased their audits of foreign controlled corporations, but IRS has not yet succeeded in sustaining examination findings. A staffing model to help allocate IRS' international resources has not been adopted yet, and a new data system to capture all examination findings is not yet in place.

Third, the IRS has moved toward using different tools, such as advance pricing agreements and arbitration, but because of IRS' limited experience with them, it is too early to tell what their eventual impact will be.

And last, the challenges of Section 482 cases will remain in the foreseeable future. Congress and IRS can expect continuing problems in this area for at least two reasons:

First, the growing global economy will likely increase the potential for underpayment of U.S. taxes; and, second, the arm's length standard will continue to be difficult to enforce. While new regulations in the area have many promising features, they still require taxpayers and IRS to collect a great deal of information and use considerable subjective judgment in Section 482 audits.

Mr. Chairman, now I will turn to taxes. As you can see in the table in front here, for each year from 1987 through 1990, about 72 percent of foreign controlled corporations paid no U.S. income taxes, compared to about 59 percent of U.S. controlled corporations.

The next table here provides information about 207 very large foreign controlled corporations that did not pay taxes in 1989. These corporations had about 10 percent of the receipts and 17 percent of assets of all foreign controlled corporations. There are about 1,500 similarly-sized U.S. controlled corporations that also did not pay taxes in 1989, had about 4 percent of the receipts and about 13 percent of the assets of all U.S. controlled corporations.

The dollar amounts at issue between IRS and taxpayers in transfer pricing cases have remained in the billions. In 1992, IRS examiners proposed Section 482 adjustments to income of at least $1 billion for foreign controlled corporations, and at least $3 billion for U.S. controlled corporations. At the end of September 1992, at least $14 billion of proposed Section 482 adjustments had been protested by taxpayers and were awaiting resolution.

IRS' recent experience with Section 482 adjustments to income and court cases has been difficult. For instance, we found that IRS' experience in appeals has not improved. While IRS examiners continue to identify billions of dollars of proposed income changes, appeals officials continue to substantially reduce previous years' pro-

posals. Fifty-two percent of Section 482 proposed adjustments were sustained in 1990. In 1991, this rate for foreign controlled corporations was 23 percent, and the rate was 28 percent for U.S. controlled corporations. However, in 1992, the rate changed to 5 percent for foreign controlled corporations and 30 percent for U.S. controlled corporations.

According to IRS, the fluctuations in rates from year to year may be due to the resolution of a few big cases. Also, IRS' experience in the courts has been disappointing. IRS lost a significant Section 482 issue with each of five corporations for which major Section 482 cases were decided between 1990 and 1992.

The courts have found that IRS abused its discretion and that its reallocation of income was unreasonable. These cases took an average of 14 years from the earliest tax years audited. They also show how such disputes can become extremely expensive for taxpayers and the government in long, drawn-out litigation.

In the broader area of managing its international operations, IRS did not meet a couple of its needs. It does not have up and running a new system for capturing all examination data, and it has not yet implemented a model to better assess its international staffing needs.

However, in its enforcement efforts, IRS has used to varying degrees certain new and existing procedural tools, such as designated summonses, advance pricing agreements and additional penalties. For most of them, we found that it is too soon to tell what the ultimate impact will be.

Turning now to international developments, Mr. Chairman, the U.S. economy has become increasingly influenced by international forces in the last 30 years. This is demonstrated by the growing amount of merchandise trade between affiliated companies. For example, merchandise exports of U.S. parent companies to their foreign affiliates increased from $6 billion in 1966 to $86 billion in 1989, and represented 24 percent of total U.S. merchandise exports in 1989.

The growing globalization of the U.S. economy poses a major challenge for IRS. The potential for underpayment of U.S. taxes increases with the number of inter-company transactions of multinational corporations.

While we do not know the exact number of such transactions, we know that the number of affiliates has increased in recent years. For example, the number of returns of foreign controlled corporations increased from about 37,000 in the mid-1980's to about 45,000 in the late 1980's.

In order to prevent tax evasion, IRS applies the arm's length standard to inter-company transactions. This standard requires that the price charged on a transaction between related corporations be the price that would have been charged if the corporations had not been related. A major obstacle in enforcing this standard has been the difficulty in finding readily identifiable comparable transactions. This has imposed a significant administrative burden on both taxpayers and IRS, and created uncertainty for corporations about their tax liabilities.

Early this year, IRS issued temporary regulations which provide guidance on determining appropriate comparable transactions, but

the task itself remains based on facts and circumstances. The regulations may ease enforcement problems by requiring increased and contemporaneous documentation. They also provide more flexibility to taxpayers in selecting their transfer pricing methods.

However, the regulations may add to the compliance burden to the extent that transactions will be documented, whether or not they are at issue with IRS.

In conclusion, Mr. Chairman, although IRS has developed new regulations and begin to expand its use of certain tools for dealing with transfer pricing issues, we do not believe the end of the transfer pricing challenge is yet in sight. The problem is large and the potential for underpayment of U.S. taxes is growing.

It is important, therefore, that IRS implement its managerial initiatives and continue to monitor the effectiveness of the regulations and its transfer pricing tools.

That concludes my oral statement, Mr. Chairman. I request that my written statement be put in the record. My colleagues and I will be pleased to respond to any questions you may have.

Thank you, sir.

Senator DORGAN. Mr. Gandhi, thank you very much. Your entire statement will be made a part of the permanent record.

Mr. GANDHI. Thank you.

Senator DORGAN. I might indicate for those in attendance today that we did ask the Internal Revenue Service to be present and testify, and they deferred. They do not have a Commissioner at this moment and are in the process of working on these issues, I think, and are not yet prepared to testify to them.

Your testimony is most interesting, Mr. Gandhi. Let me ask a question. You indicate that 72 percent of foreign corporations doing business in this country pay no Federal income taxes.

Mr. GANDHI. Yes, sir.

Senator DORGAN. That would suggest that 28 percent do pay Federal income taxes. Can you tell me how many of those 28 percent pay minuscule or minimum income taxes?

Mr. GANDHI. Well, sir, we have not studied that particular issue yet.[1]

Senator DORGAN. If the corporation had paid $1, it be among those that paid taxes, is that correct?

Mr. GANDHI. That is correct, sir.

Senator DORGAN. But you do not have a breakdown of the minimum——

Mr. GANDHI. We do not have it yet, no.

Senator DORGAN. Let me ask you a question about the process itself.

Mr. GANDHI. Yes, sir.

Senator DORGAN. Your report is a fairly dismal report with respect to the ability of the Internal Revenue Service to deal with what they are confronted with.

Mr. GANDHI. Yes, sir.

Senator DORGAN. To try to untangle, transaction-by-transaction, all of these transactions between affiliated corporations is a little

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[1] The report referred to appears on page 326.

like trying to untangle spaghetti from a large plate and take it apart strand-by-strand. It is almost impossible, it seems to me.

You talked about the new initiative at the Internal Revenue Service and the management improvements. Do you believe that management improvements and initiatives can be developed that would, in fact, solve this problem with the current system? In other words, can the "arm's length" system work, given the change in the way business is done in this world?

Mr. GANDHI. Our expectation is that these new regulations that IRS has developed should be given a chance. The reason is that the new regulations would require companies to keep an extensive set of contemporaneous documentation that they would need to document their transfer pricing practices.

The question here is what incentives the companies have to do that. Well, under the penalty provisions under the new regulations, there is a greater incentive on the part of companies to do that, and I think——

Senator DORGAN. Under the penalty provisions?

Mr. GANDHI. That is right, sir. I think the new regulations ought to be given a chance to be tried out and let's see what happens.

Senator DORGAN. Mr. Gandhi, with respect to the administration's proposal for increased penalties, isn't it generally true that people are only afraid of penalties to the extent that they are afraid that their tax avoidance might be disclosed? If one has some general feeling that they can involve themselves in highly sophisticated transactions that are not going to be discovered, penalties are relatively irrelevant.

Mr. GANDHI. Well, IRS has increased its enforcement efforts. It has put more international examiners, it has increased corporate audit rates, it has increased the number of audits of foreign controlled corporations, as well as the U.S. controlled corporations. There is a greater level of vigilance on the part of IRS lately, although I think there is always an issue of audit lottery. But given IRS' greater vigilance, again, we would like to believe at this point that the corporations would try to comply with the new regulations and Section 482, sir.

Senator DORGAN. I believe you indicated, Mr. Gandhi, that only 5 percent of auditors' assessments are sustained at the current time. We know that there are some $30 billion worth of disputes before the tax courts. You have testified to other billions in the administrative stream.

Mr. GANDHI. Yes, sir.

Senator DORGAN. What could you glean from that information that would give us some hope that ultimately we are going to resolve this problem within the current enforcement system?

Mr. GANDHI. Well, we would say that that 5 percent is indeed extraordinarily low, but as IRS has told us, the settlement of a few large cases can result in a rather low or high sustention rate, so I would not really dwell too much on that very low 5 percent.

But I think the important point here is that, as exam function develops these cases, the taxpayers have a right to appeal within the IRS, to the appeals officials, so there is a basic tension that exists between exams and appeals. The mission of appeals is to make sure that the cases are resolved without litigation, that they

are not sent to the courts until that and that the hazards of litigation are properly recognized.

So the natural inclination on the part of appeals is to indeed substantially reduce the adjustments that the exams have proposed. But I would not really at this point suggest that things are indeed going to look dismal in the future. I would let these regulations work out for a few years and see how it happens.

Senator DORGAN. Mr. Gandhi, are you familiar with or do you have an acquaintance with the work that has been done by the States with respect to formulary apportionment?

Mr. GANDHI. Somewhat, sir, yes.

Senator DORGAN. Do you believe that it can be used or that it is an appropriate model for apportioning income with respect to integrated economic units operating on the international level?

Mr. GANDHI. I think there is some promise in that. Nevertheless, I think the success of the State level should not be taken as an endorsement that it will work at the international level, sir, and for several reasons. Let me cite just as few.

One is that there is a greater uniformity of tax rates at the State level than it is possible in the international arena. At the State level, we start with 34 percent upper tax rate and build upon it. In the international arena, the rates vary from 0 to 50-plus percentage points.

Second, the economic competition among various jurisdictions within the United States is not as great as you may find in the international area. Also, the market conditions, the business environments, the pricing of goods, the different labor costs, all that vary to a greater degree in the international arena than again within the United States. So I would be somewhat hesitant to suggest at this point that that model indeed would work.

Further, I believe there is also the concern about the coordination among States. If one were to move away from the arm's length standard, I believe a greater coordination would be required with our various trading partners. But I believe, as we suggested in our 1981 report, that Treasury ought to study this in greater detail and report to Congress.

Senator DORGAN. Well, the record on that is not a particularly good record. I mean, over the last decade, I have seen scant evidence that the arm's length method is ever going to give us the enforcement we need, unless we hire a literal army of agents to try to untangle these webs of transactions and deter the transfer-pricing of profits out of this country.

Mr. GANDHI. Well, it is a problem. I believe given the complexity of the international business environment, given that it is very difficult to arrive at an arm's length standard, that you do need to develop the case for formulary apportionment, you do need to collect a wide variety of information, you do need to have expert help in devising an alternative to the arm's length prices.

But to move away from arm's length, I would say that you would need to study it in much greater detail than what has been done so far. I would also suggest that these regulations the Treasury has provided should be tried out.

Senator DORGAN. Mr. Gandhi, do not misunderstand my questions. I think your testimony is very important and very useful. I

would just say that if one looks at the evidence, the evidence you present, the evidence that is available from other sources, one can only view this system as one that is in collapse. We are losing. When I say we, I am talking about our ability to enforce our corporate tax laws, to get a fair tax payment from those who do business here. We are losing.

I have been on the other side of this table at the State level and I have seen us lose there, too. And then I have seen fundamental changes that enabled the States to win; not to get more money than they deserve, but simply to get the fair tax payment that the States rightfully expected.

So what you paint for us is a picture in which the system is not working at this moment, at least as I view it. You are saying, "Let's see if some incremental changes can be made that give the system a chance to work." But I would like to think beyond that, if we can, and see if there are structural changes that we can make that simplifies this problem for everybody—for the taxpayer and for the government alike—and still gets us where we want to go: A fair tax payment based on income that is earned in this country.

I might say that your testimony is very helpful to us and we appreciate it.

I do want to call on the Senator from Michigan, Senator Levin.

Mr. GANDHI. May I just say, sir, I appreciate your point and I particularly appreciate your experience as the tax administrator at the State level, but I think what we want to recognize here is that the situation is inherently complex.

When we go back, say, to the mid-1930, when the arm's length transaction was developed, the economic world was far more simpler. The export and import of goods were primarily compared of tangible commodities. There were identifiable market prices. Well, that has fundamentally changed. The world has become enormously complex, as you know far better than I. So I think the important point here is that we want to structure a system that would do justice to the tax administration, as well as to make sure that our trading partners are also in congruence with what we are doing here.

Senator DORGAN. Well, you make a good point. It is the very point that I make: That this problem begs for fundamental structural change. The fact is, the world has changed. But the system with which we enforce our corporate tax laws has not changed, and the result is a mess. Corporations doing business here and making money here are not paying taxes here. That is the problem.

Mr. GANDHI. Yes, sir.

Senator DORGAN. Let me call on Senator Levin from Michigan. Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, Mr. Chairman.

Let me welcome our witnesses here, also. First, Mr. Chairman, let me commend you on your leadership in this area, which began in the House of Representatives and continues here in the Senate.

We are being ripped off. That is the bottom line. We know it, and the question is what are we going to do about it. We have gotten

reports, we have gotten suggestions, we wait, we get more studies, but we are being ripped off. The numbers are clear, and to me the clearest number of them all is in your Table 3, where you indicate that the ratio of cost of goods sold, the receipts for foreign controlled corporations was at least 12 percentage points higher than the same ratio for U.S. controlled corporations.

The bottom line is transfer pricing is going on. The profits that should be taxed here, instead, are not taxed here. They are being sent back to other countries in the form of prices being paid for parts that go into the products that are being made here by those companies or in some other way.

Now, we need some strong action to end this ripoff. It is costing us billions. I don't think any other country would tolerate it. We tolerate enough nonsense in the area of trade—not being able to get into foreign markets, and using rhetoric and being delayed and being negotiated with and being intimidated. Then people threaten us with suggestions that if we try to level the playing field, we are protectionist, and all the other false arguments that we face in that area.

We just cannot afford to allow tax dodging by people who are masking money here, and I just see a continuation of a status quo, without any sharp action proposed as to how to get to it. The Chairman is right, we need some structural changes, we need some formulas to help us get at this problem, or else we are going to be negotiated and appealed to death, and we cannot afford to do it.

A few years ago, I introduced a bill in the Senate and our now-Chairman Senator Dorgan, when he was on Ways and Means in the House, along with others, introduced a Tax Equity Act in 1990. This is what our bill did. We allowed the IRS to examine transactions for more tax years than had previously been allowed, to extend the statute of limitations and we extended the coverage of the enhanced reporting requirements to all foreign corporations that carry on trade and business. We also gave the IRS some additional tools.

What you are telling us today, I gather, is that we cannot yet estimate whether or not those tools are adequate. Is that what your testimony is?

Mr. GANDHI. I think it is too early to tell.

Senator LEVIN. Can you tell us, are you able to outline for us, is this something that you or any member of the staff that is here could outline to us what options we have to strengthen our hand to end this situation?

Mr. GANDHI. I believe if we were to stay within the arm's length regime, where you want to make sure that the comparable uncontrolled transactions are considered to be the norm and the arm's length transactions would be priced as if they were at arm's length, then you would simply have to let these regulations work out.

If you were to move away from that, as some have suggested, then I think there are a variety ways one can consider.

Senator LEVIN. Can you give us what you think would be the most effective ways?

Mr. GANDHI. Well, we have not really studied that. I think the Chairman has already pointed the formulary approach, in which you would have a formula that would take into account the proper-

ty, the sales, the payroll factors, and you can have some kind of income pro-ration along those lines.

Senator LEVIN. The States that use that approach, have their formulas been tested in court? If so, what result?

Mr. GANDHI. Would you have some idea on that, Kevin?

Mr. DALY. I am not sure, tested in what sense?

Senator LEVIN. In court, have they been challenged, any State which uses this kind of a formula been challenged in court? If so, with what result?

Mr. DALY. I do not think that the use of a formula itself has been challenged. Controversies in court have to do with the extent of the unitary combination of income. There is an issue in California about California's use of worldwide combination, where they are combining income from the parent corporation that is located outside the United States with the income of the California subsidiary.

Senator DORGAN. I might say to the Senator, the States have been sued until they are blue on this issue, because a whole lot of folks didn't want the States to have a device by which they could achieve the right amount of tax payments from those doing business in the States, and that formula survives and is in place and workable and upheld by the courts.

Senator LEVIN. That was my understanding, too.

Mr. DALY. That is mine, too.

Senator LEVIN. It has been challenged and has been upheld, but you are not able to——

Mr. DALY. I am just saying that it is the traditional way for the States to apportion income.

Senator LEVIN. Have we done any studies of American companies doing business in other countries, as to whether or not there is any pattern like this, of our companies doing business in foreign countries having this same kind of a low tax impact on their profits, because of their transfer arrangements on the purchase of produces from back home, paying more than the books, reflecting a greater cost of goods sold than they should?

Mr. GANDHI. No.

Senator LEVIN. Do we know whether that pattern exists?

Mr. GANDHI. Not that we know of, sir.

Senator LEVIN. Could you check that out for us——

Mr. GANDHI. We will try.

Senator LEVIN. —to see whether or not what is true in America, which is disgraceful, with foreign corporations being able to avoid paying taxes on profits through use of transfer pricing, whether or not we would be subject to a similar argument relative to our companies' operations abroad?

Mr. GANDHI. Yes. May I just make one point here, sir, that there are also about 1,500 or so American controlled corporations who also did not pay any taxes.

Senator LEVIN. We understand, but a much greater rate for foreign owned.

Mr. OYOLA. Percentage, right?

Senator LEVIN. A much greater percentage of foreign owned.

Mr. GANDHI. No question about that.

Senator LEVIN. Obviously, there are going to be some companies, just like some people, who do not pay taxes, there is a differential

between domestic and foreign corporations, which creates the problem.

Mr. GANDHI. Yes, sir.

Senator LEVIN. Why is the suspension rate greater relative to the IRS actions relative to domestic companies vis-a-vis foreign controlled companies?

Mr. GANDHI. Larry?

Mr. KORB. I don't know if that is the case in every year. The one year we pointed out in the oral testimony where the 5 percent was compared to the 30 percent for U.S. controlled corporations, I don't think that relationship held true over time. In 1991, the numbers were closer together than they were in 1992, and I believe in the late 1980's the numbers were also closer together.

Senator LEVIN. The President has proposed some transfer pricing initiatives. Senator Dorgan, I don't know whether you have gotten into these or not. Have you?

Senator DORGAN. No.

Senator LEVIN. Are you familiar with the President's proposals on transfer pricing initiatives?

Mr. GANDHI. Yes, with the penalties.

Senator LEVIN. Can you comment on them?

Mr. GANDHI. Larry?

Mr. KORB. I think what the provisions involve is trying to close a particular exception relating to whether taxpayers are showing good faith and had a reasonable basis for their transfer pricing decisions in the past. Probably, if this sort of provision were enacted, taxpayers would be more inclined to enhance their documentation early in the process. Right now, the temporary regulations call for this contemporaneous documentation, and it looks like the penalty provisions are along the same lines.

Senator LEVIN. Do you think that the change that they are proposing in this document will be effective?

Mr. KORB. I think it will entice more taxpayers to have this contemporaneous documentation. If the documentation is available, the IRS will have more to audit when it goes in in the first place. It will not have to wait around and see if the taxpayer can produce the documentation, but it will have something to look at. The studies won't have to be developed at a later time, and the IRS won't have to necessarily come in with its own independent studies to challenge the more recent studies. It will have something to look at to begin with.

Senator LEVIN. Thank you.

Thank you, Mr. Chairman.

Senator DORGAN. Mr. Gandhi and those accompanying you, we appreciate very much your testimony today. It is very helpful to us as a base for understanding this topic, and we look forward to working with you in the coming months.

Mr. GANDHI. Thank you, sir.

Senator DORGAN. I am advised that we must make one adjustment. We have two more panels that we are going to hear from, and we are going to ask the third panel to come forward first, because two people on that panel have to go to Dulles Airport, I believe, so we want to give them the opportunity to do that.

Following that, we will have the second panel, and we will move as expeditiously as we can. We appreciate very much the patience all of you have shown.

This panel will be comprised of Dan Bucks, Executive Director of the Multistate Tax Commission, Washington, D.C.—Phil Aldape, Division Manger of the Idaho State Tax Commission, Boise, Idaho; Benjamin Miller, Associate Chief Counsel, California Franchise Tax Board, Sacramento, California; and Louis Kauder, the International Tax Attorney—not the International Tax Attorney, an international tax attorney, Washington, D.C.

Senator LEVIN. He would have settled for the International Tax Attorney.

Senator DORGAN. He probably would probably prefer the International Tax Attorney, that is right.

Senator LEVIN. It's going to happen.

Senator DORGAN. I thank all of you for being here. We would like to advise all of you that your entire statements will be made part of the permanent hearing record, and we will ask you to summarize them for us.

Let me call first on Dan Bucks, Executive Director of the Multistate State Commission.

Mr. Bucks.

TESTIMONY OF DAN L. BUCKS,[1] EXECUTIVE DIRECTOR, THE MULTISTATE TAX COMMISSION, WASHINGTON, DC

Mr. BUCKS. Mr. Chairman and members of the Committee, thank you for this opportunity to testify.

I am Dan Bucks, the Executive Director of the Multistate Tax Commission, which is an organization representing 33 States. We develop rules for States to use in dividing the income of businesses operating across State and national boundaries, and we also have real world experience in auditing corporations for taxes.

We want to commend you, Senator Dorgan, for initiating these hearings, which are directed at one of the great and unfortunate Federal policy failures of the last 30 years, the failure to require the proper reporting for tax purposes of income earned by global corporations within the U.S.

As a former State tax commissioner and former chair of the commission, you understand this problem thoroughly, and we applaud your leadership on this issue.

My messages today is simply that the Federal Government's approach to dividing and taxing the income of global corporations is doomed to fail, and that, in effect, the emperor has no clothes and is in serious need of being saved from his own embarrassment.

The Federal Government is wearing an imaginary suit of clothes called "arm's length pricing adjustments." Now, this method is largely unworkable and wastes scarce Federal and private resources. Worse yet, it fails to collect the tax revenue that is intended and causes real economic harm by shifting the tax burden unfairly to small businesses that are the main engines of job growth in America.

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[1] The prepared statement of Mr. Bucks appears on page 73.

Why are States interested in this issue? Very simply, for every dollar that the Federal Government loses because of its failure to solve this problem, States lose 22 cents. We estimate the combined State and Federal revenue loss at nearly $15 billion a year, and this is a conservative estimate, because it covers only a part of the problem, the in-bound part of the problem, as the technicians call it.

States also care about this issue, because it is their hometown businesses, their community businesses that have to shoulder a greater tax burden, when the global corporations are not asked to pay their fair share. And States also care, as well, about this issue, because many of us believe that the States have already discovered the solution to this problem in the form of formula apportionment.

The Federal Government's arm's length pricing efforts are inefficient, as compared to the formula apportionment method that States use to divide international income among different jurisdictions.

As indicated on this chart that is displayed here, the Federal Government spends, at a minimum, at least three to seven times as many staff-hours completing a partial international arm's length audit as compared to the hours that the States spend on a complete international formula apportionment audit.

Now, this comparison actually understates the greater efficiency of the States' approach, because we are actually comparing here the best case scenario the Treasury and IRS have reported with the worst case scenario of the States, as I explain in greater detail in my written testimony.

Now, does using three to seven times as much staff time as the States yield better results? Sadly, the answer is no. The Internal Revenue Service has failed to sustain its transfer pricing adjustments in every major case it has taken to court in the last 10 years. The record here is a perfect record of failure in court. I am not criticizing the IRS here, for they have dedicated and talented staff working on these issues.

The problem is that the arm's length pricing system largely impedes success. The fault lies with the policy, not with the service. Losing badly in court, the IRS has turned to settling a large portion of transfer pricing cases, and in 1981 it settled those cases for an average of 23 cents to 28 cents on the dollar. In contrast, the States have won the bulk of their international cases.

Now, please note that the States that are among the smallest in the Nation, such as North Dakota and Montana, have succeeded in administering an international apportionment system, when the Federal Government has failed to make arm's length pricing work. Sadly, the Federal Government in the mid-1980's pressured these and other States to limit their use of international apportionment.

Now, why is the Federal Government spending so much and achieving so little? Essentially, it is because the Federal arm's length pricing method attempts to do the impossible. It is impossible, because the shear volume of trade between related jointly owned corporations is too great to police on a transaction-by-transaction basis. There are 46,000 global corporations operating in the United States, doing $350 billion worth of business just amongst the related corporations within their own families.

Second, the arm's length method misplaces the burden of proof on the IRS to show that a corporation's prices are incorrect. Third, and more fundamentally, the arm's length pricing method is impossible, because it assumes an economic world that does not exist.

The method requires the IRS to discover free market prices to use as a standard to adjust the prices for the things that are exchanged in a controlled trade situation among affiliated corporations. Too often, those free market prices do not exist, and so the arm's length cases deteriorate into a debate over a range of prices, any one of which could be used because there is no right answer in these cases.

What we have is an approach to international taxation that is inefficient, ineffective and is doomed to fail. So why do we stick with a method that has failed so badly for over 30 years? The reason given time and again by Treasury officials is that "the devil makes us do it." And who is the devil in this case? International tax treaties. But is that a reasonable answer? No treaty and no law should require anyone to do that which is impossible. If they do, they should be changed.

Further, and this is very important, the major treaties do not speak of adjusting prices to an arm's length level at all. In fact, what the treaties speak of is adjusting profits in a manner that achieves an arm's length result. Treasury could, if it so decided and without revising the treaties, explore with other treaty partners developing formula apportionment processes that adjust profits, instead of prices. Indeed, one can argue that Treasury has precisely a responsibility to do just that.

Thirty years go, the U.S. Government led its trading partners down the arm's length pricing path. We now know that path has reached a dead end, and it is time for the U.S. Government, through Treasury, to lead its trading partners down a new path of dividing profits through formula apportionment.

The Federal Government is parading naked in the international tax arena. It is time for this emperor to get a suit of clothes. He will not find a good suit of clothes in London, Brussels, Berlin, or Tokyo, and he will certainly not find them in the Cayman Islands or Netherlands Antilles. The emperor will find a good suit of clothes in Sacramento, Salem, Helena, Boise, and Bismarck—and when he finds this suit of clothes, he will discover that they fit well, they are warm and comfortable, are a good value for the money, and will last a long, long time.

Thank you very much.

Senator DORGAN. Mr. Bucks, thank you very much.

Next we will hear from Phil Aldape—and I hope I pronounced your name right—Division Manger, Idaho State Tax Commission, Boise, Idaho.

Mr. Aldape, am I correct?

Mr. ALDAPE. Aldape.

Senator DORGAN. Aldape, close. Thank you for being with us.

TESTIMONY OF PHILIP M. ALDAPE,[1] DIVISION MANAGER, IDAHO STATE TAX COMMISSION, BOISE, IDAHO

Mr. ALDAPE. Mr. Chairman, my name is Phil Aldape. I am the administrator of the Audit and Collections Division of the Idaho State Tax Commission. I have worked for the tax commission for 24 years, nearly all of which time has been spent as an audit manager or as a lead auditor in audits of multistate and multinational corporation income tax returns.

Over this period of time, we have audited thousands of tax returns filed by these companies.

I am here today to tell you about our experience with Section 482 and to try to compare it to formula apportionment. We have had one significant experience with a Section 482 audit. It involved the transfer of 100 percent of the stock of a subsidiary of an Idaho corporation which was in the oil and gas business and had properties throughout the United States. That stock was transferred from the Idaho corporation to its parent, which was based outside the State.

Based upon a prior agreement that the Tax Commission had entered into with the Idaho corporation, we were obligated to use the separate entity method of accounting and, as a result, had to use the Section 482 approach to determine, first of all, the fair market value of the stock that was transferred out of state and the gain that should have resulted from that transaction, since the taxpayer reported no gain in the return as filed.

In our audit, we experienced considerable resistance from the taxpayer. We ran into a considerable amount of confusing and conflicting data in their records and we spent weeks researching industry publications to try to determine how to go about valuing this stock. We ended up conducting two appraisals, one by a CPA and experienced auditor on our staff who used a comparable sales approach for determining that value, and another by two senior appraisers in our ad valorem and estate tax audit units. They valued the proven and probable reserves of that oil and gas subsidiary, to determine the amount of the value and the gain that should have been reported.

These two appraisals determined values ranging between $14 and $16 million, that is gains that should have been reported of $14 to $16 million. And following our appraisal, the taxpayer felt obligated to do one of his own. Their appraisal acknowledged that the gain should have been $8 million, where none was originally reported.

This case progressed and we ultimately settled while we were in the process of pending litigation. We had planned to hire an expert to do an appraisal to support our audit. We expected from the information we had that we would have had to pay $50,000 to $75,000 for this expert witness. We were told that we needed to do this, if we expected to win the case, because in valuation cases such as this, the winner is typically the party with the most credible witness.

As it was, we spent 2,000 hours on this case, compared to approximately 200 hours that we typically spend on apportionment

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[1] The prepared statement of Mr. Aldape appears on page 86.

audits. If we had used the combined reporting formula apportionment method, there would have been no gain to report, because the inter-company activity would have been eliminated. Instead, Idaho would have shared in any production income from that oil and gas subsidiary and from any sales of underlying assets in that property.

Our conclusion from this experience and training that we have participated in on the arm's length method basically led us to conclude that the arm's length pricing method is ridiculously impractical.

We use combined reporting. We think it is much easier. It can't be manipulated by less than arm's length pricing. In Idaho, there are two methods of combined reporting or formula apportionment. The first is one that may be elected by the taxpayer, which we call a waters edge method. Under this method, there are still artificial boundaries between U.S. and foreign operations, and that provides opportunities for taxpayers to give us arm's length pricing problems.

We, unfortunately, have to rely upon the IRS, and while we are pleased to do that by comparison to nothing, we understand, because of the difficulties that they have with Section 482, that those companies are likely paying us less than they should.

The worldwide combined reporting approach, which is typical among taxpayers in Idaho, is a better approach, in our minds. There are no arm's length issues to deal with in that approach. It includes only income that results from transactions with unrelated entities.

Mr. Chairman, we urge you and your colleagues to substitute the apportionment concepts that the States have successfully used for years for the arm's length approach or, in the alternative, to modify Section 482 to use formula apportionment when the arm's length method doesn't work. We think that the formula approach at the Federal level will ease compliance, make reporting more verifiable and improve equity among all taxpayers.

Thank you for the opportunity to speak to you. I would be happy to answer any questions.

Senator DORGAN. Mr. Aldape, thank you very much.

Next, we will hear from Mr. Benjamin Miller, Associate Chief Counsel, the California Franchise Tax Board, in Sacramento.

Mr. Miller.

TESTIMONY OF BENJAMIN F. MILLER,[1] ASSOCIATE CHIEF COUNSEL, CALIFORNIA FRANCHISE TAX BOARD, SACRAMENTO, CALIFORNIA

Mr. MILLER. Thank you, Chairman Dorgan.

My name is Benjamin F. Miller. I am an attorney with the State of California, and I am here representing the Franchise Tax Board and its executive officer, Gerald H. Goldberg. Mr. Goldberg has asked me to convey his greetings to you, he shared tax commissioner positions with you at one time, and to express his apologies for not being able to be here with you today. He had previously sched-

[1] The prepared statement of Mr. Miller appears on page 92.

uled a conference in California which, since he was hosting, he was unable to leave.

I have prepared written testimony which has been submitted to the Committee, and I intend to only briefly summarize that and perhaps even depart from it somewhat, to respond to some of the things that I have already heard this afternoon.

California and the Franchise Tax Board probably has more experience with formulary apportionment that any other State in the Union, particularly in terms of combined reporting and the worldwide combined reporting method. We have used this method for over 60 years.

For the last 20 years, while I have been practicing with California, I have been directly involved in the administration and implementation of this method. I have been involved in representation of the board before the U.S. Supreme Court. We have three cases currently pending, one of which is at the Supreme Court now on a petition and two more which are likely to be there shortly involving the worldwide unitary method.

I have worked and studied transfer pricing, I have participated in the Federal study of that method with Senator Conrad, with the working group which was appointed by President Reagan. I have received IRS training in international audits. I will probably be in charge of our legal support to our own international audit efforts, our Section 482 efforts.

I have co-authored or co-drafted legislation which California adopted to go to the waters edge. I have co-drafted the regulations which implemented that. I have also drafted the regulations which we used to implement worldwide combined reporting when foreign entities are involved.

There are two specific areas I would like to touch on. First, the case that we are litigation with Barclays, the case now pending before the U.S. Supreme Court, there are a couple of things that should be mentioned about that case.

The concerns or the reservations of the litigation which is involved involves the question as to whether California can constitutionally apply this method, and constitutionally in terms of its effect upon foreign affairs and whether, under the Commerce Clause, there is permission to do it. There is not an issue in that case that the tax which California has assessed is a fair tax or that it is an inaccurate tax. The question is whether we can use this formulary apportionment method.

The formula used is the standard three-factor formula. Senator Levin asked earlier as to whether there was litigation with respect to the applicability of that formula. Yes, there is. The Container Corporation case in 1983 sustained that three-factor formula as the benchmark by which all these questions should be measured.

Now, when you look at the unitary method, we basically only need seven numbers to determine the level of taxation, the amount of income which a corporation or a business should assign to California. First, we need to know what is overall income. If the corporation has no income everywhere, then it doesn't have to pay us a tax. If it has income, then they are going to pay a tax on an apportioned share of that income. So there is taxpayer equity involved, and it is income determined by true third-party transactions, be-

cause it disregards all inter-group transactions. It is only that transactions that take place with respect to third parties. So that is the first number we need.

The second, third, and fourth numbers are the worldwide property, payroll and sales of that corporate group. The fifth, sixth, and seventh numbers are the property, payroll and sales of that business which occur within our particular State. Now, we believe every single business has those numbers available to it on its own internal accounting records, records which are maintained for internal purposes and which are maintained for other purposes, reporting to shareholders and for outside review, which are independently verified and sustainable.

Thereafter, once we have those seven numbers, it is merely a matter of mathematical calculation to determine how much income should be assigned to a particular jurisdiction and what the tax would be. It is a very simple process.

Now, in the Barclays case, one of the questions that has arisen, one of the arguments that is often made with respect to formulary apportionment is that it is that the cost involved in complying with it is excessive, but we believe that is a smoke and mirrors cost. It is an illusion. As my example, I will use Barclays.

Barclays offered testimony in our trial court, testimony supported by a partner in a major accounting firm, that the cost for them to set up a system to comply with California would be in the millions of dollars. Now, they talked about setting up a separate system. They talked about having to make accounting adjustments without determining whether there was a difference between a foreign accounting treatment and the tax accounting treatment. They talked about having to convert all these items into dollars, rather than do it in the foreign currency.

In doing all this, they ignored the regulations which we had written. Those regulations provide that we start with the financial accounting data, the consolidated financial accounting data of the business. We deal with it in the currency in which they normally report.

We only require accounting adjustments to be made where they are material. And in the Barclays case, we actually had an SEC filing document, which, again, a major accounting firm had prepared, which indicated there were only five differences between United Kingdom generally accepted accounting principles and United States generally accepted accounting principles.

Only one of those had a tax consequence and with respect to that one item, which is an item where the United Kingdom allows you to revalue your assets to reflect inflation, on the books of the corporation, there is a reserve set up which reflects that reevaluation amount. So in order to make an adjustment to return the books to an original cost basis, you have the item in the accounting data which you can go to and make that adjustment, so the information exists.

It ignored the provisions of our regulation, which indicate the calculations are to be made in the foreign currency, and it is only when you come to a bottom line number, the amount of income assigned to California, that you have to make the conversion to a dollar item. In fact, the testimony that was offered to that simple

mathematical calculation of taking a known exchange rate divide into a known income figure would take hours, perhaps a day. It is simply ludicrous to think about that kind of testimony in these days of hand-held calculators.

In response to the taxpayer's offer, we went out and we requested the bills which a major accounting firm had sent the taxpayer for the preparation and filing of a worldwide combined report with California. We obtained 3 years worth of bills. They reflected a charge for filing those returns of between $990 to $1,250. not thousands, not millions, but an average of less than $1,000.

Now, it is true, it will be pointed out, that with respect to those returns, the Franchise Tax Board did not accept those returns. There was a very good reason we did not accept those. Those accounted for the results of a single corporation and all of its particular subsidiaries, but those were the results of Barclays international banking operations. They involved over 30 subsidiaries, and they involved activities in over 70 countries. The change we required to go to was to pick up the parent bank, the United Kingdom bank and the banking subsidiaries and other subsidiaries in the United Kingdom.

But the point to be made with respect to that data is the data which they prepared that return on came from the financial records of Barclays' bank group. All we were asking them to do was to take a step up in those records, go to the records for the whole overall group, not just the activities which were present in California. So the information to prepare the return was there, was available. It did not require additional cost to bring it together or prepare or collect it.

We have a similar experience in another foreign parent case we are litigation, the Alcan case. Again, an estimate to prepare a California worldwide combined report of over $10 million. Actual facts: This corporation prepared worldwide combined reports with California which were accepted. For 2 years, they estimated the costs at less than 25,000. For another 3 years, they estimated the costs to be less than $75,000. Where is the $10 million figure?

There is a third case and this one not as directly involved, but it involves the State of New York and its attempt to tax the Reuters News Agency. Here again, we have 3 years involved. For the first year, Reuters filed on a method New York requires, which included the worldwide activities of that corporation. For the second and third year, they attempted to file just on their activities in the State of New York. New York said no, that's not our system, you have to reflect your worldwide activities. They made estimates based upon the financial records of Reuters and it issues assessments accordingly.

Reuters protested. They came into the New York tax agency and they claimed it would cost them a million dollars to prepare the necessary returns. The courts in New York found those figures to be grossly exaggerated on the reliance of two items. One, they had filed the return for one of the years that New York required, and they did not think they had spent a million dollars to prepare that return, and Reuters offered no evidence as to what it in fact cost.

Then, second, with respect to the other two years, once it became clear that New York was not going to change its position, it took

Reuters all of 10 days to submit the data to have their assessments reduced by roughly 75 percent and to conform to the method which New York required. The million-dollar cost was clearly a smoke and mirrors item.

The second thing I would like to address is what the consequences might be if the United States was to adopt something similar to the formulary apportionment method, a unitary methodology.

Two summers ago, as you are well aware, the Pickle committee, the House Ways and Means Committee, with Chairman Pickle presiding, held studies on the question of how much tax was being avoided by foreign based multinationals. One of the items involved in that Committee hearing was a staff report which reviewed the Federal tax returns over a 10-year period for a number of foreign corporations and found that those corporations had paid on an average of about $22.5 million of Federal tax or a total taxable income per return of approximately $45 million.

Now, we are not sure those numbers are completely accurate, because, unfortunately, the testimony or the study that was offered to the Committee does not indicate what the effects of operating losses might have been on that overall number. Nonetheless, using that as a baseline number, during the course of the hearings, one of the Representatives set forth a list of companies which he had obtained not from the IRS, but from other sources, private sources which he believed were involved in those studies, major Japanese corporations, basically, all names which would be recognized.

We were curious to see what the results of those corporations would be in California, so we went back and looked at the tax returns which they had filed with us and those which we had audited and adjusted, and we have since updated that in preparation for this hearing.

What we found was that those corporations had reported under worldwide combined reporting an average of $25 million of income assigned to California. That is a smaller number than the Federal number, but, remember, what we are talking about is only the amount of income they assigned to California, and rightfully so. Assuming California is only a portion of the United States, you can start making upward adjustments of that number.

If you assume California represents half the United States, you double the number and all of a sudden we have $50 million of U.S. income, an amount 11 percent higher than what was reported to the Federal Government.

If you go to other assumptions, for example, California represents one-eighth of the United States, a number we frequently use for revenue estimating purposes, that number becomes $200 million per return. Now, we think that eight times is probably too high an increase here, because these are Japanese companies and, in all likelihood, they have a greater presence in California than they do other States within the United States. But you get some notion of the magnitude of what might be involved here.

Now, let me point out, I am not suggesting that this is the amount of money which could be recovered under arm's length accounting. What I am saying is this is the amount of money which

could be recovered, if the United States was to use something like the unitary methodology which the States have used.

In summary, I would like to say that, based upon my experience, I would agree with the United States Supreme Court that the formulary apportionment of the unitary method is a fair and proper method. I believe it is easier to administer than the arm's length method, that is more certain in its results, and it is a more effective means of collecting revenue.

The Franchise Tax Board does applaud your efforts in holding this hearing, your concern with this issue, and your willingness to explore new alternatives. But we would like to point out that what is being proposed with respect to the arm's length method is merely band-aids on a system. This system is hemorrhaging. Band-aids are not the proper medical treatment, when you have hemorrhaging occurring.

Thank you very much.

Senator DORGAN. Mr. Miller, thank you very much.

Next, we will hear from Louis Kauder, an International Tax Attorney here in Washington, D.C.

Mr. Kauder.

TESTIMONY OF LOUIS M. KAUDER,[1] INTERNATIONAL TAX ATTORNEY, WASHINGTON, DC

Mr. KAUDER. Thank you, Senator.

I have submitted my written statement for the record and I will only summarize it. Quickly, my three points are that the present system is defective. I agree with the other witnesses. It does not work. It cannot be made to work. I think it also should be replaced. In most cases——

Senator DORGAN. Mr. Kauder, just for purposes of this hearing, could you give me just as bit of your background?

Mr. KAUDER. Yes, it is in my written statement. I was a tax lawyer for the U.S. Government in both the Justice Department and the Treasury Department in the 1960's and early 1970's. For 3½ years, in particular, I was with the Office of International Tax Counsel at Treasury and my duties there especially were focused on transfer pricing. I was involved in tax treaty negotiations and had particular duties with respect to the related party article, that is the transfer pricing article, in the treaties.

I drafted and conducted and executed Treasury's first survey of administration of the transfer pricing regulations that at that time were new, and I drafted the first Treasury report published in January of 1973 on transfer pricing.

Shortly after that I prepared a paper for the United Nations, at their request, on the problems of administration and compliance in connection with related party transfer pricing issues. I have been in tax practice in Washington ever since. I published a paper recently that recommended that Treasury adopt formulary apportionment.

The current system relies just about entirely on comparable prices, and everyone who addresses the issue agrees that it is very

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[1] The prepared statement of Mr. Kauder appears on page 102.

difficult to find them. My point to you today, Senator, is the present system does not simply result in just a neutral standoff or impasse. I think that the advantage lies, unfortunately, with the taxpayers, and I would like to summarize a couple of points in that regard.

I think we have to recognize that multinational firms are each unique unto themselves. They have their own cultures and their own spirit and their own way of doing things, and there has been a lot of literature and theoretical and empirical studies in that regard.

The point today is that those differences from one to the other, even within the same industry, provide fertile ground for distinguishing any comparables that are offered up by the IRS to address the transfer pricing used by a multinational.

Each multinational has a command of its own facts and its own character that the IRS can never match. The IRS can never have an equivalent command of what the multinational itself is doing, and it will never have an equivalent command of the industry that the multinational is a part of. Yet, it is the command of that kind of data and those kinds of facts and understandings that is required to achieve an adequate and reasonable result, if you have to go out and find comparable prices.

The government does have one major advantage. It is its only advantage. It gets to write the rules. However, I have come to the conclusion that the government has dissipated that advantage. The problem is that when the decision-maker in a court, or even at the IRS appeals office level, confronts the circumstance where we have a set of rules that are highly subjective, inconclusive, extremely difficult to apply, it is the government itself that is responsible for writing those rules.

It is hard to see that the government is entitled to win those disputes and to prevail in those disputes, when there are legitimate differences or at least colorable differences between the government and the taxpayers. I think instinctively, and perhaps in some unspoken way, that is one of the reasons why the government loses case after case in the courts.

There is another point about the comparable uncontrolled price methodology. It fundamentally addresses an issue of valuation, and tax lawyers and tax administrators are very comfortable dealing with the problem of valuation. There are many circumstances in which garden variety valuation issues have to be dealt with in any tax system.

I think in connection with international transfer pricing, it is very, very treacherous. Where you have excise tax or estate tax issues and you have disputes over value and those disputes rise to a level of 10 percent or 15 percent or 20 percent of the amount involved, you are still at the margins of the tax base.

When you have a corporate income tax that rests so heavily on subjective valuation issues, a 10 percent or even a 5 percent swing dissipates the tax base entirely and you are subject to a total evisceration of the tax base. For myself, looking at some of the data that has been produced in the last couple of years, I think that we can see that process happening. I do not think that process was an-

ticipated 25–30 years ago, when the comparable price methodology was put in place.

Let met talk about my recommendation and that of others that formula apportionment is a solution. The methodology has been described by other people here. I don't know that the three-fact formula used by the States is precisely the one that we ought to use. But I do believe that one or several apportionment formulas should produce what I believe would be efficient, precise and fair results.

I think it is important to establish that an apportionment formula methodology is not and should not constitute a U.S. grab for international income. I think that properly designed and promptly designed apportionment formulae could be explained and developed to easily dispel any notion that the United States is grabbing for international income that it is not entitled to tax.

The value of apportionment is that it would eliminate these references to outside transactions, and there would be no further bloodletting of that kind on this issue. I would certainly recommend and provide, as my statement indicates, some exceptions. There are cases where you wouldn't have to use formula apportionment.

Last, I would turn to the tax treaty issue. I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into. It is often said, as you have noted today, Senator, that apportionment, if we adopted it, would violate the arm's length standard. Therefore, it is time to ask what is arm's length.

To me, Senator, arm's length is nothing more than an exhortation to be fair and reasonable. The phrase itself, I note, Senator, does not appear in any treaty provision. I think that today it has become a ritualistic incantation and that it has no content. In my view, whatever it is, it is not a rule of law.

There is no limit in any U.S. treaty on what methods the United States or any other country can use to test multinational transfer pricing choices. The exhortation of arm's length says that we have to approximate a reasonable result. Comparable uncontrolled prices and comparable prices in connection with cost-plus markups and so forth are a means of reasonably approximating a fair result. Formula apportionment can be exactly the same.

We do not need any treaty permission from other countries to make Section 482 adjustments. There has never been international agreements on the specifics of the methods by which related party transfer pricing can be examined domestically.

There is, of course, Senator, a potential of double taxation whenever one country makes a related party adjustment. Our treaties provide procedural rules by which the countries commit themselves to try to resolve any differences between them, if the two countries don't agree after the first country makes an adjustment.

There is nothing in the treaties that recites how those methods should be used in the first instance. Further, and irrespective of what method is used by the first country, we do not know whether the second country is or is not going to agree. Each case is decided on its own facts. We have never, Senator, gotten another country to agree, for example, that our comparable uncontrolled price

methodologies, if we rely on them precisely and perfectly, will achieve double taxation relief on the other side.

Our treaties do not go that far. International accords have not reached that point. And we are no more protected from double taxation today with respect to comparable uncontrolled prices, in reality, case-by-case than we would be, in my view, if we had formula apportionment.

I think that if we go to formula apportionment, there wilt be threats of retaliation. I think that in the end, any retaliatory action would itself likely violate the non-discrimination clauses of our treaties, and I don't think, in the end, that foreign countries are going to widely discriminate against U.S. based companies.

Even today, in competent authority proceedings, according to the data recently collected, only a small percentage of IRS Section 482 adjustments find their way to the competent authority. That suggests perhaps that a large number of these adjustments do not generate double taxation. It may also suggest that there are many adjustments made on the other side without the competent authorities being involved.

I don't know exactly what the answer is, but, in my view, formula apportionment adopted by the IRS is not likely to produce greater double taxation or any greater threat of retaliation against U.S. companies than the circumstances we have today.

I would urge the IRS, as I have in writing, to go to that method, to go to it reasonably promptly, and when they do, I think they should explain their motive to the foreign countries. The foreign countries have the same kinds of problems, and we should establish that formulary apportionment is not a grab by the U.S. for international income.

Thank you.

Senator DORGAN. Mr. Kauder, thank you very much.

I would like to depart from standard practice, if I might. Are you able to stay for a bit, Mr. Kauder?

Mr. KAUDER. Yes, I am.

Senator DORGAN. I know the others have to catch an airplane in a bit. But I would like to ask the remaining three witnesses to come forward and just spread those chairs out. I would like to hear from those witnesses, and then I would like to have a broader question session here. So I would like to ask, Mr. McIntyre, if you would take a couple of those front chairs and move them forward to the table.

Mr. McIntyre, who is Director of Citizens for Tax Justice, is with us; Professor Dale Wickham, from the American University, Professional-in-Residence in the International and Tax Policy area is with us; and Kevin Kearns, who is President of the U.S. Business and Industrial Council.

I appreciate your willingness to scoot towards the table. I would like to ask the three of you to summarize, as well. I would like to call first on Mr. Robert McIntyre, Director of Citizens for Tax Justice.

Mr. McIntyre, your entire statement will be made a part of the record, and you may summarize.

TESTIMONY OF ROBERT S. McINTYRE,[1] DIRECTOR, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. McINTYRE. Thank you, Mr. Chairman.

After listening to the previous, balanced panel, I am persuaded. I think we should go to formula apportionment. That is the gist of my testimony. We have heard a lot today about the problems with the current system. It's kind of wacky. If you had to summarize it, I guess you'd say that we're telling companies and the IRS that they have to assign accurate, what's called transfer prices, to transactions that may never actually have occurred, in any formal sense, and to base those transfer prices on comparable "arm's length" deals that not only may not exist, but often are almost impossible to conceive of existing.

This isn't a system that makes theoretical sense and it's certainly not one that makes practical sense. I'm in complete agreement with the rest of the panel here that we need to move as quickly as possible away from that system and towards something that does make sense, that the States have proven makes sense: A formula apportionment system.

Now, let me offer you something specific. It's at the end of my written testimony.

This fight has been going on for many years. Ever since the United States adopted the arm's length approach in the 1960's, people have been trying to change to a formula system. We have an opportunity, I think, in connection with the North American Free Trade Agreement, to actually put a formula system in place on a limited basis for North America. This first step would be much easier to achieve than trying to persuade all our trading partners all over the world to go along with this system (and we do need to bring them along, to avoid the kind of irritations you otherwise would have).

So I think that the Committee should put as much pressure as possible on our Treasury Department and on the Clinton Administration, as part of the North American Free Trade Agreement, to say, let's sit down, renegotiate our tax treaties with Canada and Mexico. Our testimony offers some detailed suggestions on how those treaties ought to be renegotiated, so that we can have a formula system for North America.

This is something that will be of extremely high interest to the European Community, which is facing the same issues as it lowers trade barriers and is discovering that, even its value-added taxes don't work when you don't have barriers and customs barriers. They will be very interested, I think, in seeing how it works here and seeing if they should adopt it there. I think it would be the first step that would really be practical for us to move towards world-wide combined reporting, which I think is definitely going to happen if we have any intention of taxing multinational corporations fairly.

Thank you.

Senator DORGAN. Mr. McIntyre, thank you very much.

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[1] The prepared statement of Mr. McIntyre appears on page 123.

Next we will hear from Professor Dale Wickham, the American University, distinguished Professional-in-Residence for International and Tax Policy.

TESTIMONY OF DALE W. WICKHAM,[1] THE AMERICAN UNIVERSITY, INTERNATIONAL AND TAX POLICY, WICKHAM & ASSOCIATES, WASHINGTON, DC

Mr. WICKHAM. Thank you, Mr. Chairman.

It is a pleasure to be with you to discuss possible new directions for dealing with transfer pricing and other techniques for apportioning international business income for income tax purposes.

To identify myself, I am Dale Wickham. I teach law at the American University in Washington, D.C., where I am on the faculty of the Kogod College of Business Administration as Distinguished Professional-in-Residence for International and Tax Policy. I teach courses in the graduate and undergraduate tax programs there.

In that connection, I have had two articles that I've prepared and published recently on various aspects of international transfer pricing and on other, and I think preferable, approaches to apportionment of international business income. Both of those articles have been made available to Committee members and staff and are attached to my written statement I have submitted for inclusion in the record.

I also practice law in Washington, D.C., as I have since 1956, specializing in Federal tax matters in both domestic and international transactions, counseling and representing taxpayers, especially large international business taxpayers, in their dealings with the Internal Revenue Service and other tax authorities. I am currently in practice in my own firm of Wickham & Associates here in Washington.

I am appearing here today, however, not as a representative of anyone else, but simply to express my own views on the subject matter you are working on that have developed from my work both in public service, private practice, and my work in academia.

I should say that I was, from 1959 until the end of the Revenue Act of 1962, a staff attorney on the Joint Committee on Internal Revenue Taxation, where I worked on tax treaties and other international tax matters, and served as technical advisor to the Foreign Relations Committee on tax treaty matters. I later served as special counsel to the U.S. Senate Committee on Finance for the Tax Reform Act of 1969.

I might say that the views I am expressing to you here today are substantially the same as ones I expressed last July in an appearance I was invited to make before Mr. Pickel's Oversight Subcommittee of the House Committee on Ways and Means when they were considering H.R. 5270, an omnibus bill for revision of U.S. taxation of international business transactions.

Possible new directions for dealing with problems concerning multinational apportionment of international business income are the focus of my attention here today. There are enormous problems being generated by the arm's length transfer pricing approach

[1] The prepared statement of Mr. Wickham appears on page 130.

which the Treasury and the IRS adopted by regulations first proposed in 1966 and finally promulgated in 1968, which they have since advocated for adoption by other countries and they are still urging Congress to retain. I think new directions are badly needed and I have some to suggest.

But as a historical background and perspective note, I would like to note that my own interest in finding solutions to problems in this area really began more than 30 years ago when I was on the staff of the Joint Committee on Taxation working on tax treaties. I noticed there were only 2 tax treaties then in force that had a comprehensive set of bilaterally agreed rules of source to govern which country had the right to tax income from a given set of international business transactions and which would then be used by the country of residence to allow its foreign tax credit for taxes paid to the source country.

The lack of international agreement on that subject was striking, and the lack of efforts to seek it was also striking.

At about the same time, I was one of a number of staff members working on a proposal to amend Code Section 482 which was being resisted stoutly by certain officials in the IRS on grounds that that section ought to be left for them to interpret and apply case-by-case on a so-called *in terrorem* basis, and they thought the rule should be left vague. The House-passed version of the Revenue Act of 1962 had in that proposal which is still highly relevant to the proceedings you have before you today. I refer to it in my written statement in note 2. I would like to just pause for a moment and read from the House Ways and Means Committee report accompanying Section 6 of H.R. 10650, which was the House version of the Revenue Act of 1962, which proposed to add the new provision which would have provided three-factor apportionment among commonly controlled units of an international business' income from the sale of goods, and that would have been required to be used unless the taxpayer could demonstrate that an arm's length price would be a better way of clearly reflecting income.

Now that provision was dropped by the Senate, but the conference agreement included language in which the conferees said they thought the Treasury now has the power——

Senator DORGAN. What year was that, Mr. Wickham?

Mr. WICKHAM. Pardon?

Senator DORGAN. What year was that?

Mr. WICKHAM. This was 1962, a little over 30 years ago. The House Committee report accompanying this said, "However, in practice, the difficulties in determining a fair price under this provision"—that is Section 482 essentially as it exists today in the first sentence—"severely limits the usefulness of this power, especially where there are thousands of different transactions engaged in between a domestic company and its foreign subsidiary. Because of the difficulty in using the present Section 482, your Committee has added a subsection to this provision authorizing the Secretary of the Treasury's delegate to allocate income in the case of sales or purchase between a U.S. corporation and its controlled foreign subsidiary on the basis of the U.S. proportion of the assets, compensation of the officers and employees, and advertising, selling, and sales promotion expenses attributable to the United States and at-

tributable to foreign country or countries involved. This will enable the Secretary to make an allocation of the taxable income of the group involved to the extent it is attributable to the sales in question, whereas in the past under the existing Section 482, he has attempted only to determine the fair market sales price of the goods in question and built up from this the taxable income, a process much more difficult and requiring more detailed computations than the allocation rule permitted by the bill."

As a matter of fact, Mr. Chairman, I think the language I just quoted from the conference agreement and the Section 6 of H.R. 10650 might be added to footnote 2 of my written statement because of its current relevance to activities and work on the Treasury regulations in this area and a possible take-off point for legislative activity. With your permission, I would add that to that footnote of the written statement.

Senator DORGAN. Without objection, that will be added.

Mr. WICKHAM. Now, the words that the Ways and Means Committee used in that report are prophetic, because at that point we did not have the internationalization of business transactions that has developed since. That has made enormously increassed demands on the system, which even in 1962 the Committee on Ways and Means thought was inadequate to the task. Well, it has since become even clearer, in our view, that the transfer pricing technique is a horse-and-buggy mechanism that is really outmoded and not at all capable of dealing with the enormous pressures being put upon it.

I think that the events of the 30 years since 1962 and the decision of the Congress not to require the Treasury and the IRS to use specific factor apportionment provide powerful testimony to the magnitude of the problems that are connected with adherence to the case-by-case, after-the-fact transfer pricing approach on which the Treasury and the IRS have been insisting. These problems are merely outlined in my written statement but are developed much further in the articles we submitted. They can only grow larger with the increasing internationalization of business and with increasing demands of revenue-hungry countries, such as the U.S., who are looking for larger shares of taxes on income from international business.

I believe that the search by this Committee for solutions to problems under the present system could be more to the point and more productive if it is founded on a sharper definition of some of the problems presented. I think that the Treasury and Service's recommendations for strengthening the enforcement powers on the present system (information-gathering, increase of audit force,etc.) evades the central problem involved, which is the absence of a workable set of rules; a full army of international examining agents is not going to solve the problems that we have.

I think we should look a little more carefully at some of those problems. I just want to identify four problems, each of which is, although related to the other, separate from the other. It's important to do that so that we are not looking for one solution to all the problems. There are different problems and different solutions needed.

I note that all the core problems really are caused by failures of government, not by taxpayer abuse or evasion, as is so commonly asserted. Each one of these is a problem where change could only be effected through governmental actions by the United States or by the other countries involved.

The first problem is the lack of rules that are reducible to numbers required on income tax returns. How much should a conscientious taxpayer report on his return to the United States, on its return to Germany, to Italy, and to the various other countries with which its business transactions have contact?

Those questions are simply not the subject of rules of law where a conscientious taxpayer can find the answers, especially where there are no comparables. That is a very large number of cases under the present system. That lack of rules informing the taxpayer about what is expected and that are reducible to numbers required on tax returns defeats the U.S. system for voluntary self-assessment of tax in this area of the law. That necessitates a case-by-case, after-the-fact approach which brings ill effects that pervade the system at all levels, clear on through competent authority proceedings.

The habit in some countries other than the United States has been for taxation by negotiation and by agreement, frequently secret agreement, but that's not the U.S. tradition. The U.S. tradition is to have the government play its part of laying out what is expected of a taxpayer and what he should do in his tax return, and then to generate the forces of good will and conscientiousness on the part of them in complying with it. That is being destroyed by the present lack of rules, and it can only be supplied, not by enforcement of no rules, but by development of some new rules which work.

This lack of rules is very costly. As a matter of fact, the Service and Treasury in their appearances before the Congress never make a report of the total cost and the total benefits of the present transfer pricing system. There is no cost-benefit analysis supplied to the Congress or to the Office of Management and Budget about what the present case-by-case system for enforcement under Section 482 costs. We in our articles have suggested that the Congress insist on annual reporting and a cost-benefit analysis of the kind that is required under Executive Order 12291. This should be done on a comprehensive, system-wide basis, so that the Congress and the Service and the Treasury and policymakers can see what is it costing. What are the system-wide costs for revenue agents and for enforcement of the system, and what revenue benefits are those costs bringing us?

That is especially important, as some of the others have indicated. The Service's record in Section 482 cases is dismal. It has a record of losing these cases. What is the United States getting out of the entire effort? Is it costing us more than it is yielding in revenues? It is an important area and I think it might be of special interest in the jurisdiction of the Governmental Affairs Committee.

There is a second problem, and that is——

Senator Dorgan. Mr. Wickham, I want you to summarize this because I need to get to Mr. Kearns so I have time for questions.

Mr. WICKHAM. I will put aside further statements of the problems and just move quickly to what I think the solutions are.

The first is to supply rules that are reducible numbers required on tax returns instead of having no rules or illusory rules.

The second is to abandon the focus on inter-company transfer pricing and focus instead on geographically apportioning combined income or loss of the multinational enterprises involved.

The third is to move toward coordinating our rules of source with our rules under Section 482 for apportioning income.

Finally, I recommend that the United States, under our new President, take the initiative to formulate and to secure multinational agreement to a single new set of definitive rules for geographically allocating the source of any income or loss derived from international business transactions. Preferably this would be accomplished through a single, multilateral treaty to which agreement would be sought by all nations having significant international business transactions and which would enter into force with respect to each signatory country as it agrees.

That would take quite a bit of time, and meanwhile, there are several steps that we think the United States could take to amend the temporary and proposed regulations under Section 482, and if they do not do it, steps that the Congress might take legislatively to cause some changes in direction in this area.

With that, Mr. Chairman, I will suspend and be glad to participate in trying to answer any questions.

Senator DORGAN. Mr. Wickham, thank you very much. Your testimony is excellent and I hate to shorten it.

Incidentally, I taught economics in college for a couple of years, and I, too, every time I had the opportunity to say something, wanted to give the full lesson. But your full lesson is a very good lesson and I appreciate very much the excellent testimony.

Mr. Kearns, would you proceed, please?

TESTIMONY OF KEVIN L. KEARNS,[1] PRESIDENT, UNITED STATES BUSINESS AND INDUSTRIAL COUNCIL, WASHINGTON, DC

Mr. KEARNS. Thank you, Mr. Chairman. I commend you for holding this hearing. You did great work in the House when you were on Ways and Means and the Pickle Subcommittee held its hearings there, and it is good to see you in the Senate, taking up this issue again.

Now, I think maybe my value added for the hearing is to step back and look at the political context just for a minute or 2 and dispense with the remarks that I had based on my written testimony.

It seems to me that almost everyone here today is in agreement that our system is broken and it is broken very badly. So then the question arises, why don't we fix it? Why did Chairman Pickle hold hearings over 2 years ago and nothing has been done since then to engage in a major overhaul of the system. I think that from the point of view of my members, I represent 1,500 American-owned businesses, they do not have the luxury of plants overseas and to

[1] The prepared statement of Mr. Kearns appears on page 232.

be able to engage in transfer pricing which, in effect, is a fancy form of money-laundering, move their profits around the world to the country with the lowest rate of taxation, etc.

So what happens often in the popular press, there is a debate that is going on and it is American multinationals versus foreign multinationals, and it is the little guys, my manufacturing companies and even their employees, as taxpayers, who get stuck with the bill in this clash of political and economic ideology among the multinationals. So I do not want us to lose sight of that in talking about the various technical fixes to the solution.

What I would like to address just for a minute or 2 is what I would call the 10 myths supported by proponents of the role of foreign corporations on our society—actually, proponents of tax avoidance by foreign corporations. And I will just go quickly through these 10 and then sum up my remarks.

Myth No. 1 is that anyone who wants a foreign corporation to pay more taxes is a protectionist nut. A lot of people have spoken here today; I do not think there are any nuts in this room. This is not a question of protectionism; it is a fundamental question of fairness for the American people, for the American taxpayer.

The second myth is that the money simply is not there. President Clinton had the courage in this political campaign to take on this issue and I hope somehow the word of this hearing gets over to the White House today to let him know that there are a lot of small companies and medium-sized companies in America that very much want him to continue his campaign in this regard and to fulfill his campaign promise.

I look back at articles in the papers since he has been elected and I see Mr. Goldberg, who is Commissioner of the IRS now, saying, "Well, gee, the money is not there." Yet at hearings at which you were present before Mr. Pickle, he said, "Well"—Mr. Pickle asked, "We understand it is $20, $30, $40 billion"—he said, "Well, maybe not that much but it is certainly in the billions of dollars." Now this myth is that the money is not there.

Myth No. 3 is, well, maybe some money is there, but it is really not what Mr. Clinton said, it is not $45 billion, and then the stories go on to say, well, it is really more like $28 billion, or something like that, so he is $17 billion short. Well, as Senator Dirksen once said, you know, "A billion here, a billion there adds up when you are talking about real money."

Just as a taxpayer myself, to go after an addition $10, $15, $20 billion is a significant sum. It lightens my tax burden; it makes American companies more competitive, internationally and domestically, when their tax burdens are lowered.

Myth No. 4 is that enforcing U.S. tax law uniformly will have a devastating effect on foreign investment flow into the United States or that foreign firms located here will somehow move immediately to locate elsewhere. I suggest that simply is not true. This is still the largest, most richest market in the world. If you are going to play in international competition, you have to be in the U.S. market. Foreign firms are not going to pull out wholesale.

Myth No. 5 is that foreign direct investment is some sort of panacea from the United States, that as these transfer pricing effects are felt in this country and American firms are weakened by

market share grabs with additional retained earnings through transfer pricing, you know, we have to be thankful that foreign companies come in and pick up the pieces.

At a hearing over at the House side a couple of years ago, Congressman Oxlee, who is from Ohio, said—I've been on the back side of the dais when I worked on Senate Foreign Relations, and he was conferring with his counsel and I could tell they thought they had me—and he said, his first question was, "Are you upset that Honda created"—whatever it was—"2,500 jobs in my district?" I said, "No, I'm not, but what about the 70,000 jobs lost in other areas of Ohio and Michigan and other States throughout the United States?" There is more than one congressional district, more than one interest at work here.

There are no studies of which I am aware, and I have looked at the field very closely, that say foreign direct investment is a net gain to the United States, that it creates net jobs. Sure, the day the Honda plant opens there may be 2,500 additional jobs in the United States, but if 2 years later a whole bunch of suppliers are out of business and 5,000, 10,000 or 15,000 Americans are out of work in other portions of the country or other portions of the State, foreign direct investment has done nothing for the United States.

Myth No. 6: Enforcing the tax laws will cost American jobs. And this notion is that well, gee, if we chase these foreign companies away, American firms that are supplying them will somehow lose business, they will not be able to supply them if they move to, say, Mexico or Canada or Southeast Asia. But in fact, many of these foreign firms, especially the Japanese firms, do not allow American companies to supply them in the first place, and that is why they are not a panacea.

In terms of their presence in the U.S. market, they import an awful lot of stuff from overseas and they cut out American suppliers who had traditionally supplied American industry, so there are real problems there.

The notion, Myth No. 7, enforcing the tax law will invite reciprocity from other countries, I think our other witnesses have been through that. The tax laws and tax treaties, we can work these things out with our trading partners. I do not think necessarily there is going to be some swift sword of retribution.

Myth No. 8 is that foreign firms do not engage in transfer pricing because the marginal rates of taxation are higher in their home countries. Japanese tax rates are higher, so that if you transfer your profits from your U.S. affiliate back to the parent company in Japan, you are going to wind up with a much higher tax burden. I suppose theoretically that is true, but in fact there are all sorts of mechanisms in the Japanese tax law that are not available under U.S. tax law where Japanese corporations can avoid paying taxes.

I would like to submit for the record an unpublished paper by John Stearn of the American Electronics Association in Tokyo. It is called, "Technotax: How Japan's Tax System Spurs Technology Development." [1]

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[1] The document referred to appears on page 262.

Senator DORGAN. Without objection, we will put it in the record.

Mr. KEARNS. Mr. Stearn lists 132 tax breaks related to technology development that are simply unavailable in this country.

So the point is, you can shelter, in many cases foreign companies can shelter a lot more income in their home country which makes a higher marginal rate of taxation irrelevant, essentially.

Myth No. 9 and 10 essentially we have discussed today, and they are that we should not bother going after this problem because the IRS has not been successful, and litigation results on pennies on the dollar. It would cost a certain amount of money for the first 3 years while we would train additional auditors and economists, etc., and there would be no pay-back over the short term. Well, this is typical short-term American thinking, which our corporations, or many of them, have turned around in the last 10 years, and I think our government and our Congress have to take a long-term look at that. It is worth the investment to do something about this problem. Simply because it is broken does not mean that we should not fix it, that we will not be successful in fixing it.

Finally, I would like to say, Mr. Chairman, that there is also—and whatever you could do to break this deadlock, there is a 3-way deadlock inside our Executive Branch between the Commerce Department, Bureau of the Census, Treasury's IRS, and Treasury's Customs Service.

My suspicion is, although since a lot of the information is privileged, I cannot prove this, but my suspicion is, foreign corporations are submitting three different sets of data to these agencies. Now, they submit one set of data to Customs when they enter goods in the United States, they submit another set of data to the Bureau of the Census when Census does various tabulations about the state of U.S. industry, and they submit a third set of data when they pay their taxes to IRS. And we have, in the new Secretary of the Treasury, Secretary Bentsen, someone who is very concerned about this. He held hearings on the Honda customs duty avoidance case which is still pending, and I think maybe a direct appeal to him to try to get two agencies under his control, IRS and Customs, talking and sharing data, there's an awful lot that can be done informally. I think we need some legislation, too, in the case of IRS, but essentially in different agencies of our government, we have the information we need to go after tax cheating and to make the IRS' job, even in the meanwhile, even as we look at alternative solutions, much easier.

The information is there, there is no question about it. But we have gridlock inside the Executive Branch.

Finally, Mr. Chairman, I'd like to suggest a private remedy for American companies that is rather novel, and I would also like to submit for the record a *Law Review* article that is called, "RICO"—the Racketeer Influence Corrupt Organizations Act—"Meets Keiretsu: A Response to Predatory Transfer Pricing," by Jim Harmon,[1] who is an attorney who was formerly involved in organized crime cases. The beauty of the RICO statute is that private American companies can collect treble damages if they are success-

[1] The article referred to appears on page 284.

ful. They are the ones being damaged. Obviously, our government is being damaged by not collecting revenues, but also private American companies are being damaged in the marketplace. And while those companies, up until now or up until looking at RICO or thinking about it, they really have to wait for us here in Washington to try to fix the system, to argue about this, to debate about this, and there seems to be no remedy for them to go after damages themselves to recoup the losses that they faced, in effect, by paying taxes while foreign corporations are cheating on theirs.

Mr. Harmon lays out a very extensive and thorough case for private remedy for American companies damaged by these foreign corrupt practices, to try to recover some of the damages.

Mr. KEARNS. So in summation I would say, Mr. Chairman, that you and we who want to change the system face a rather difficult fight. There is more or less an unholy alliance between foreign corporations operating in the United States through subsidiaries with free trade ideology that says let's not have any barriers to trade, taxation seems to be one of those barriers, and between a lot of lawyers and lobbyists in this town who are perfectly happy to make a lot of money advising foreign corporations.

I can show you pamphlets where Big Eight accounting firms advertise, hey, we'll help you beat U.S. taxes, you know, come and retain us. There is an article from the Financial Times from 2 weeks ago, March 5, 1993, and a group of U.S. lawyers held a meeting at the American Chamber of Commerce in London and said that you're going to have to retain our services if you want to defeat Mr. Clinton's plans to tax you. So there are a lot of vested interests here, and again, I commend you on holding this hearing. The solutions are rather obvious, but we have a lot of work to do to defeat those vested interests.

Thank you.

Senator DORGAN. Thank you, Mr. Kearns, very much.

I should say that while we asked the Internal Revenue Service to come today and they were not able to at this point, it was not my intention to promote a debate between those who believe the system should change and those who believe the system is remarkably effective the way it is. Those who now like the system and take full advantage of the system have had their day and will have their day in the future.

My interest today was to hear from the GAO and to hear from others who have written and thought about and worked on these questions—in particular, on whether a strong case can be made for change. I think the answer is yes. I felt that way before, but I am even more convinced after much of the discussion today. That was the purpose of this hearing.

There will be other hearings and, believe me, those who feel very strongly opposed to change will have their day in court in a thousand different ways and on a thousand different days. They are very adept at that. That was not the purpose of this particular hearing.

Let me ask some questions, and again, I appreciate the patience that all of you have exhibited today.

First, if the government were to change its fundamental approach in a more aggressive way than has been proposed by the bu-

reaucracy, at the moment, the affected taxpayers would say that this is merely an attempt to maximize revenue and, in fact, truck in revenue from other jurisdictions to be taxed in the United States. In fact, before we had formulary apportionment, California was more aggressive than most of the States and there was something that we called the California Hog Rule, which meant that anything anybody else did not get, California wanted as tax base.

Some would suggest that if the Federal Government is going to move in this direction in an aggressive way, maybe it simply wants to import taxes from other nations, import tax base from other nations, so it can extract from foreign corporations as much as it can possibly get.

Mr. Bucks, will moving to a formulary apportionment cause any danger that foreign corporations will be over-taxed?

Mr. Bucks. Mr. Chairman, I do not believe so at all, and I would like to say that the formulary apportionment system would establish a level playing field for all the kinds of businesses that are really affected, that is, the foreign corporations that are operating through subsidiaries in the United States, the U.S. multinationals who operate abroad, as well as the small businesses that report only here in the United States. It creates a fair, equitable, level playing field system.

Formulary apportionment does not attempt to take some type of unreasonable share of the income that is being earned. To the contrary, the precise object of formulary apportionment is to have income reported with certainty that reasonably reflects the economic activity that is being carried on within a jurisdiction, and in this case——

Senator Dorgan. So it is a protection for the taxpayer as well as for the government to be sure that there is not over-counting, as well as under-counting?

Mr. Bucks. That is correct, and I want to emphasize, and I think from the standpoint of the commission, we think the problem is not a problem that is limited to foreign multinationals. We think this is a problem that occurs—the current system—the problem is not with the corporations. The problem is with the system and the system is one that causes difficulties regardless of the Nationality of the company. It is too complicated. It simply does not work, and a formulary apportionment system is fair and equitable, and that is what the Supreme Court has said whenever it has looked at that.

Senator Dorgan. That is an important point I have used as well. In fact, the problem exists with respect to all integrated economic units doing business in many jurisdictions. It is not just foreign corporations.

Mr. McIntyre, is it possible that those particular foreign corporations that are on this chart are not paying taxes because they are not earning money here? Might that be the simple answer?

Mr. McIntyre. I think it is certainly true for some of them, but for those big ones, no. The problem is transfer pricing. And we catch them in crazy traps, you know. One of those big transfer pricing cases came up when Toyota was accused of dumping its cars here, charging its U.S. subsidiary too little. So Toyota raised its prices and that wiped out its taxable U.S. profits through transfer pricing, so Toyota did not pay any U.S. taxes.

The system is crazy, the way it works. Obviously, Toyota and companies like that should be paying American taxes, and if we have a system where they are either accused of violating our trade laws or violating our income tax laws, no matter what they do, the system does not work.

Senator DORGAN. Mr. Kauder and perhaps Mr. Wickham, as well, both of you I think are saying that the Federal Government can accomplish a change in fundamental policy probably without a change in law, just a change in will at Treasury and the IRS—a decision to move forward and use formulary apportionment. Is that the position that both of you take?

Mr. WICKHAM. Well, speaking for myself, I can say that is so. We concluded in our article as a matter of law that neither Section 482 of the statute nor any existing bilateral tax treaty to which the United States is a party, precludes the Internal Revenue Service in the pending regulations (as you know, there is outstanding a temporary regulation and also a proposed regulation which includes a profit split proposal in it) which precludes the IRS and Treasury from acting to promulgate a regulation which permits profit-splitting by reference to pre-identified factors, such as in formulary apportionment.

Now, there are practical issues. To prevent double taxation or under-taxation, one needs to have agreement with one's trading partners, just as the States in UDIPTA and the Multistate Task Commission reflect their u nderstanding of the importance of getting agreement on application of these apportionment rules. But as a matter of law, there is no statutory change that is required, in my view, to authorize the Treasury and the Service to amend their regulations to stop putting all this priority on transfer pricing and even without abandoning an arm's length method, and to just using apportionment, sometimes called profit-splitting by reference to factors. That is viewed in many quarters as an arm's length method—not an arm's length pricing method—but an arm's length method.

Senator DORGAN. Mr. Kauder.

Mr. KAUDER. Yes. I have written on the subject, Senator. No statutory amendment is required to adopt and enforce formulary apportionment. In my view, no one could claim that that method violates any treaty provision that we have entered into, and we would have the same circumstance under the treaties that we have today.

In each individual case, the other country is going to decide whether the result of our adjustment is something that they are going to accommodate on the other side. They either will or they will not, based upon whatever they take into account today. We have no assurance today, if we go out and find a comparable price, that the other country is going to accept it.

Also, we should not lose sight of the fact that the tax base itself has to be re-established and to the extent apportionment simply enlarges the tax base, there is no double taxation implicated.

Senator DORGAN. Let me ask either one of you another question. The administration has proposed temporary regulations here and changes. Some say, well, obviously this is evidence that we are moving toward solving the problem. Does this solve the problem?

Mr. WICKHAM. I do not see it that way at all. It is simply a continuation of the old order arm's length transfer pricing. It is trying valiantly to hold to that old standard, the unworkability which is already well established. I mean, 30 years of evidence—how much more do we need to know that it is not working? They are holding steadfastly and tenaciously to that standard with a lot of very, very detailed rules, all to what end? Proving comparable transfer prices. Too many of us know from practice that there are not comparables to be found in a lot of major situations.

We ought to get with the business that—I see some people in the IRS are beginning to talk about doing it in so-called global trading rules. They are coming up with what are the factors that we ought to be looking at to determine how much of the income the United States should tax versus how much the foreign countries should tax.

The temporary regulation that was proposed does nothing but perpetuate the existing arm's length pricing system and it keeps the focus of attention away from where it needs to be. What are the rules to be for determining fair share, of this country or the other countries? Precise rules that are reducible numbers on tax returns by auditing agents, by taxpayers, and so on.

Senator DORGAN. Mr. Kauder, do you have anything to add to that?

Mr. KAUDER. Yes, I have a metaphor that is in my written statement. The situation is like organizing an Easter egg hunt without first hiding any eggs. No matter how many children are invited to join in the search and no matter how detailed the instructions are for finding the eggs, none will be found because none are out there, and I think that is my view of the most recent set of regulations.

It is the same old story. It is stewing up the same pot. And I will not take the time here, but the whole history from 1986, when Congress amended Section 482, and then we had the 1988 white paper and then we had the 1992 regs and the 1993 regs, if you see the extraordinary shifts in position at each stage, you can only conclude that the people who were doing this work are simply spinning around in a stationary position. And that is too bad. That is not harmless.

Senator DORGAN. And so the temporary regs in which we prescribe greater penalties, if they find eggs, really become irrelevant if there are no eggs to find. It is a good metaphor, perhaps.

Mr. Kearns, you indicated that people talk about the need for change in the way we do this are described as "protectionists" or "nuts." I understand that. There is a sort of fraternity in this town of international thinkers. They are the ones that know. They are the ones that have all the information and are able to make judgments, and anybody outside that fraternity is supposedly not capable of understanding the true dimensions of the various problems.

You represent a group of American businesses, I understand. You heard me say that I agree with Mr. Bucks and, I believe Mr. McIntyre that this is not just an issue of foreign corporations doing business in this country. In fact, the example I described at the start of this hearing—the 19 file boxes of paper and probably wonderful incomes and new homes for attorneys and accountants who participated in 10 years or 12 years of dispute—had to do with an

American corporation and a subsidiary in Singapore that made airplane parts and transfer-priced the profits out of this country.

So, the problem is not just with foreign corporations doing business in this country. Do you agree?

Mr. KEARNS. Oh, absolutely. One of the points I was making when I said that the voice of small business really has not been heard is that small business is not only hurt by foreign corporations engaging in these practices, but by large American multinationals engaging in these practices, also.

We are here, we do not go anywhere. Good times and bad, we are manufacturing in the United States, more or less, depending on the economic conditions, but we do not have the luxury that any multinational does to move profits around to a country with a low tax rate or offering tax holidays, etc.

So I think that the problem can be on both sides—both the American multinationals and the foreign multinationals—and the behavior, if they are engaging purposely in tax avoidance, the behavior is reprehensible in either case.

Senator DORGAN. A quick question for Mr. Aldape and Mr. Miller: My assumption is, if you did not have a formulary approach with which to audit, you would not have an audit program. My assumption is, you simply would not have the resources with which to even begin a transaction by transaction analysis of related corporate entities. Is that the case?

Mr. ALDAPE. Mr. Chairman, in the case of a State like Idaho, that is absolutely the case. There is no way that we could practically get into the business of auditing these types of taxpayers relative to their activity in Idaho under the arm's length pricing type approach.

Mr. MILLER. For the State of California, Senator Dorgan, we are about to find out. We have embarked upon our own arm's length audit program. As of the first of the year, I believe we have about half a dozen taxpayers who we have approached on that basis and we are going to develop our own experience.

In terms of the legislation we passed when we went to the water's edge, there is an assumption, a presumption attached to IRS adjustments in the area. If the IRS is in fact auditing people in this area, then we are going to have to live with what they go by, and so what we are aiming at companies different than the IRS has been auditing, and there are some areas where our law is different than the IRS's, very specifically the 936 corporations—and I do not know whether eager is the right word—we at least would like to try this and see what happens with it and develop our own experience and see how it compares to what the IRS has been able to do.

I do not hold out great hope for it, but we are certainly going to try.

Senator DORGAN. One of the points made by Mr. Wickham that I think is important is that this country is a leader in these areas. If this country and this President decides—and I hope he will—that he is going to exert leadership and say, "Here is the direction we need to go. We need an international agreement on how to apportion income between the various countries;" if we could provide that leadership, in the next decade we could change the interna-

tional rules on how this income is reported. That would obviously add revenue, which we need; but it would also create a situation that is more fair for the smaller enterprises that stay in one place and must pay their taxes. Another salutary effect for the country is that it would shut down an enormous amount of economic activity—tax lawyers and so forth—that I view as useless and hopefully put those good minds to other work, useful work.

This testimony today has been very helpful in furthering the understanding that we could in fact change the current approach, that we could encourage the Administration, the Treasury, the Internal Revenue Service, to change this approach and set in motion a whole series of advantageous results from that.

I want to thank all of you for excellent testimony, and we will continue additional hearings on this subject in the future.

I am going to ask also, with unanimous consent, that we include testimony from Frances Zuniga [1] in the permanent testimony of this hearing.

Senator DORGAN. Thank you all very much.

The hearing is now adjourned.

[Whereupon, at 3:43 p.m., the Committee was adjourned.]

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[1] The prepared statement of Ms. Zuniga appears on page 317.

APPENDIX

UPDATED INFORMATION ON
TRANSFER PRICING

SUMMARY STATEMENT OF
NATWAR M. GANDHI
ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

For each year from 1987 through 1990, about 72 percent of foreign-controlled corporations paid no U.S. income tax, compared to about 59 percent of U.S.-controlled corporations. The 207 foreign-controlled corporations with assets of $250 million or more that did not pay tax in 1989 received about 10 percent of the receipts and had 17 percent of the assets of all foreign-controlled corporations. Although data showing differences between foreign- and U.S.-controlled corporations could indicate potential transfer price abuse by foreign-controlled corporations, they do not prove such abuse.

The dollar amounts at issue between IRS and taxpayers in transfer pricing cases have remained large. IRS in 1992 proposed section 482 adjustments of at least $1 billion for foreign-controlled corporations and at least $3.1 billion for U.S.-controlled corporations. On September 30, 1992, at least $14.4 billion of proposed section 482 adjustments had been protested by taxpayers to IRS' Appeals division and were awaiting resolution.

IRS' recent experience with section 482 cases has been difficult. In 1992, Appeals sustained only 24 percent of the dollar amount of section 482 adjustments proposed by IRS examiners. Also, IRS lost a significant section 482 issue for each of the five corporations that had a major section 482 case litigated and ruled on by a court between 1990 and 1992.

In the broader area of managing its international operations, IRS did not meet a couple of its acknowledged needs. It did not have operational a new system for capturing examination data that was to be used for 1992, and it had not yet implemented a staffing model to better assess its international staffing needs.

The challenges of section 482 cases will remain for at least two reasons. First, the growing influence of international forces on the U.S. economy will continue to increase the potential for underpayment of U.S. taxes through transfer pricing practices of multinational companies. This influence is demonstrated by the growing amount of merchandise exports of U.S. parent companies to their foreign affiliates, which increased from $6 billion in 1966 to $86 billion in 1989 and represented 24 percent of total U.S. merchandise exports in 1989. Second, while the new, temporary transfer pricing regulations have many promising features, they still require taxpayers and IRS examiners to collect great amounts of information and use considerable subjective judgment to compute arm's length prices.

Mr. Chairman and Members of the Committee:

We are pleased to be here today--at Senator Dorgan's request--to provide you information about transfer pricing[1] issues facing the Internal Revenue Service (IRS), specifically in the areas of tax payments of foreign-controlled corporations, exams, appeals, litigation, and new transfer pricing regulations. This information updates that published in our 1992 report, International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (GAO/GGD-92-89, June 15,1992).

Today we have four major points:

--Our review of 1989 and 1990 tax data showed that, as in previous years, a larger percentage of foreign-controlled corporations than U.S.-controlled corporations paid no income taxes in the United States.

--IRS' experience in dealing with transfer pricing issues has continued to be difficult, and the dollar amounts at stake have remained large. IRS examiners have increased their audits of foreign-controlled corporations, but IRS has not yet succeeded in sustaining examination findings from previous years through the appeals process and the courts.

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[1]Transfer prices are prices companies charge other related companies for goods and services transferred on an intercompany basis.

A staffing model to help allocate international staffing resources has not yet been adopted, and a new data system to capture all examination findings is not yet in place.

--IRS has moved toward using different tools in the transfer pricing area, such as advance pricing agreements and arbitration, but because of IRS' limited experience with them, it is too early to tell what their eventual impact will be.

--The challenges of section 482[2] cases will remain in the foreseeable future. Congress and IRS can expect continuing problems in this area for at least two reasons:

--First, the growing global economy will likely increase the number of cross-border transactions and thus the potential for underpayment of U.S. taxes through transfer pricing practices of multinational companies.

--Second, the arm's length standard--which is the standard the United States and other countries use to govern transfer pricing--will continue to be difficult for IRS to enforce. While new regulations in the area

[2]Section 482 of the Internal Revenue Code gives the Treasury Secretary broad authority to allocate income among related parties in order to prevent tax evasion or clearly reflect the income of the parties.

have many promising features, they still require taxpayers and IRS examiners to collect a great deal of information and use considerable subjective judgment to compute arm's length prices in an increasingly complex international business environment.

HIGHER PERCENTAGE OF FOREIGN-CONTROLLED CORPORATIONS DID NOT PAY TAX

As shown in table 1, for each year from 1987 through 1990, about 72 percent of foreign-controlled corporations paid no U.S. income tax, compared to about 59 percent of U.S.-controlled corporations.[3] We examined the nonpaying corporations by their 1989 asset size and found that 29,781 foreign-controlled corporations had assets lower than $10 million and paid no income tax. These foreign-controlled companies comprised 66 percent of all foreign-controlled corporations, but they had only 3 percent of the receipts and about 2 percent of the assets of all foreign-controlled corporations. Similarly sized U.S.-controlled corporations that did not pay income taxes represented about 58 percent of all U.S.-controlled corporations.

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[3]Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

In the group of very large corporations--that is, those with $250 million or more in assets--207 of 693 foreign-controlled corporations did not pay taxes. These large, foreign-controlled corporations had about 10 percent of the receipts and 17 percent of the assets of all foreign-controlled corporations. In comparison, 1,555 of 4,650 U.S.-controlled corporations with $250 million or more in assets did not pay tax in 1989. These large corporations had about 4 percent of the receipts and about 13 percent of the assets of all U.S.-controlled corporations. More information about foreign- and U.S.-controlled corporations and whether they paid taxes is provided in table 2 and appendix I.

Table 1: Foreign- and U.S.-Controlled Corporations Paying No Taxes, 1987 to 1990

	Foreign-controlled corporations		U.S.-controlled corporations	
	Number of returns	Percent	Number of returns	Percent
1987	29,928	71	1,333,470	57
1988	33,636	73	1,310,698	58
1989	32,135	72	1,265,970	59
1990 (preliminary)	32,323	73	1,264,349	61

Note: These percentages are based on tax returns as filed and do not reflect IRS audits or net operating loss carrybacks that would result from any losses in future years. Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Source: IRS data.

Table 2: Foreign- and U.S.-Controlled Corporations With Assets Equal to or Greater Than $250 Million That Paid or Did Not Pay Income Taxes for 1989

	Large foreign-controlled corporations (FCCs) that did not pay U.S. income tax		Large U.S.-controlled corporations (USCCs) that did not pay U.S. income tax	
		Percent of large FCCs		Percent of large USCCs
Returns	207	30	1,555	33
Receipts (million)	$94,956	14	$341,620	7
Assets (million)	$243,226	21	$1,904,803	15
	Large foreign-controlled corporations that paid U.S. income tax		**Large U.S.-controlled corporations that paid U.S. income tax**	
		Percent of large FCCs		Percent of large USCCs
Returns	486	70	3,095	67
Receipts (million)	$584,329	86	$4,705,449	93
Assets (million)	$935,649	79	$10,892,026	85
Taxes (million)	$4,193	100	$64,434	100

Note: Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Source: IRS data.

We examined several categories of expenses and deductions claimed by corporations in 1989 and found that the ratio of cost of goods sold to receipts for foreign-controlled corporations was at least 12 percentage points higher than the same ratio for U.S.-controlled corporations. (See table 3.) Although data showing

differences between foreign- and U.S.-controlled corporations could indicate potential transfer price abuse by foreign-controlled corporations, they do not prove such abuse. We concluded in our 1992 report that other factors, such as attempts to increase market share, newness of investment, extent of leverage, and fluctuating exchange rates can also contribute to the differences.

Table 3: Percentage of Cost of Goods Sold, Interest, and Net Operating Loss Deductions for Foreign- and U.S.-Controlled Corporations in 1989

	Foreign-controlled corporations		U.S.-controlled corporations	
	Did not pay tax	Paid tax	Did not pay tax	Paid tax
Cost of goods sold/receipts	69.9%	67.4%	55.2%	55.4%
Interest paid/receipts	9.2%	6.2%	8.2%	8.2%
Net operating loss deduction/receipts	0.2%	0.7%	0.5%	0.4%
Taxes/receipts	0.0%	0.8%	0.0%	1.3%

Note: Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Source: IRS data.

IRS' EXPERIENCES WITH TRANSFER PRICING IN EXAMINATIONS, APPEALS, AND LITIGATION

IRS examiners continue to propose substantial section 482 adjustments to income. However, IRS appeals officers, who are

charged with resolving tax controversies without litigation, continue to substantially reduce adjustments proposed by examiners. Further, IRS has been unsuccessful in litigating important section 482 cases in the courts.

IRS' Examination of Section 482 Issues

IRS uses audits to encourage corporations to comply with section 482 and detect those who do not. In the wake of congressional oversight of IRS' transfer pricing enforcement activities, IRS increased the number of international examiners by 19 percent, from 490 in fiscal year 1990 to 582 examiners in fiscal year 1992. At about the same time, IRS increased the audit rate for foreign-controlled corporations from 1.3 percent[4] to 3.5 percent--1,666 actual 1992 examinations of 47,000 corporations.[5]

The amount of proposed adjustments to income that IRS has identified in audits is in the billions of dollars. For example, in 1992, for cases with total proposed adjustments of $20 million or more, IRS proposed section 482 adjustments of $1 billion for foreign-controlled corporations and $3.1 billion for U.S.-controlled corporations. (See table 4.)

[4]IRS testified in 1990 that it planned to examine 600 of 45,000 corporations.

[5]The long-term trend for IRS audits of all corporations--both with and without international components--was generally downward in the 1980s. In 1980, the audit rate for all corporations was 6.5 percent. In 1991 the rate was 2.4 percent.

Table 4: Proposed Section 482 Income Adjustments of Foreign- and U.S.-Controlled Corporations With $20 Million or More of Total Proposed Adjustments

Dollars in billions

	Foreign-controlled corporations		U.S.-controlled corporations		Total	
	Firms	Adjustment amount	Firms	Adjustment amount	Firms	Adjustment amount
1989	12	$0.7	31	$4.1	43	$4.8
1990	11	$1.6	26	$4.4	37	$6.0
1991	12	$1.1	23	$1.2	35	$2.3
1992	13	$1.0	37	$3.1	50	$4.1

Note: A few large adjustments significantly affect comparisons of adjustments for foreign- and U.S.-controlled corporations since they comprise large percentages of the totals.

Source: IRS data.

Reliable breakouts of IRS examinations with proposed adjustments under $20 million and their section 482 proposed adjustments were not available. Although we reported last year that a new system for capturing examination data was to be used for 1992, this system for capturing all examination findings is not yet in place. IRS' goal is to have it operational in fiscal year 1993.

In trying to determine the amount of IRS staff time spent on section 482, we found that IRS does not have a system for capturing staff time used on individual Internal Revenue Code sections. Using a formula provided by IRS, however, we estimated that in fiscal year 1992, IRS spent about 19 economist staff years and 164 international examiner staff years on examinations

that had a section 482 adjustment among other issues. The international examiner time was about 40 percent of international examiners' time spent on all closed international examinations.

We also found that for cases with proposed adjustments of $20 million or more, 71 percent of international examination time went to cases with one or more section 482 issues in fiscal year 1992. According to an IRS analysis of these cases, which IRS cautioned is skewed by a few large cases and combined several types and sizes of taxpayers, it took over twice as many hours per year to examine a corporation with a section 482 issue as it did to examine one without the issue.

Section 482 cases resulted in more projected tax per hour of examination for U.S.-controlled corporations but less tax per examination hour for foreign-controlled corporations. In terms of projected tax divided by examination hours, audits of U.S.-controlled corporations with section 482 issues were twice as productive ($25,766) as those without these issues ($12,955). However, the productivity of audits of foreign-controlled corporations with section 482 issues ($20,436) was less than those without section 482 issues ($23,558).

In a related matter, an internal IRS report in mid-1991[6] and our 1992 report recommended that IRS implement a staffing model to better assess international staffing needs overall as well as on audits of other than the largest corporations. IRS has not yet implemented such a model but is studying how best to do it. Its goal for having the model in place is September 30, 1993.

It will be a while before the impact of the staffing model, the new system capturing examination data, and the continuing section 482 examination findings can be assessed. For example, the IRS Appeals Division's experience that I will describe next relates in great part to section 482 examinations done in previous years, and not to examinations recently completed.

Appeals Continues to Reduce Income Adjustments Proposed in Examinations

When adjustments or penalties are proposed in an examination of a return, the taxpayer can take the dispute to Appeals, which is the administrative body within IRS authorized to settle tax controversies. We found that IRS' experience with section 482 issues in Appeals has not improved. While IRS examiners continued to identify billions of dollars of proposed income

[6]IRS, Strategic Initiative SVC-17, Positioning IRS for the Evolving International Economy: Issue Focus and Program Measurement, 1991.

changes in section 482 issues, IRS' appeals officials substantially reduced previous years' proposals.

Open Issues[7]

As of September 30, 1992, Appeals had 352 proposed section 482 adjustments worth $14.4 billion, as opposed to the $13.1 billion of outstanding adjustments as of April 30, 1991.[8] Of the $14.4 billion of adjustments, $2.4 billion were for foreign-controlled corporations. IRS reported that, as of September 30, 1991, one-third of all open international appeals dollars and one-tenth of all open appeals dollars were linked to section 482.

Closed Issues

We reported last year that 29 percent of section 482 proposed adjustments to income were sustained in IRS' appeals process in 1987 through 1989.[9] This number rose to 52 percent in 1990.

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[7]"Open" issues are issues referred to Appeals but not yet settled by appeals officers. "Closed" issues are issues where settlement has been reached.

[8]Appeals does not track every issue related to section 482 but believes it captures the large ones by focusing on the largest issues in cases that meet certain tax deficiency criteria.

[9]The sustention rate is defined as the ratio of the adjustment amount determined after Appeals' settlement of an issue to the adjustment amount proposed by examiners. IRS heavily qualifies sustention rates because the data collected for 1987 through 1989 were not gathered to measure sustention rates.

In 1991 the sustention rate was 23 percent for foreign-controlled corporations, and it was 28 percent for U.S.-controlled corporations. However, in 1992 the sustention rate changed to 5 percent for foreign-controlled corporations and to 30 percent for U.S.-controlled corporations. According to IRS officials, the fluctuation in sustention rates for section 482 from year to year might be due to the resolution of a few cases with large dollar implications.

In fiscal year 1992, Appeals closed 163 transfer pricing cases. Examiners originally proposed a net income increase of $1.9 billion, but Appeals officers reduced the adjustments by $1.5 billion. As a result, Appeals sustained only 24 percent, or $467 million, of the proposed adjustments. The majority of the 163 closed cases--138--involved U.S.-controlled corporations.

Reasons for Reaching a Settlement in Appeals

In recent years, IRS began tracking the reasons why the appeals process reached a particular settlement in particular cases. According to Appeals data, the principal reason for reducing the adjustments in fiscal year 1992 was concern about whether the court would apply the same judgment to the evidence as IRS had. This reason accounted for 40 percent, or $588 million, of the $1.5 billion reduction in the original proposed income adjustments. As I will discuss in the following section, we

found that IRS examiners in many audits exercised considerable subjective judgment to estimate arm's length prices in cases in which no comparable uncontrolled prices existed.

Two other reasons accounted for another 31 percent of the reduction. These were that (1) section 482 proposed adjustments were reduced because an alternative strategy for adjusting a taxpayer's income produced a better result for the government according to Appeals and (2) new facts or evidence were obtained and evaluated by Appeals or IRS' Chief Counsel.

IRS' Experience with Transfer Pricing Issues in the Courts Has Not Been Favorable

IRS' experience in the courts with section 482 has been disappointing. We identified all five corporations for which major section 482 cases had been decided by various courts between January 1, 1990, and December 31, 1992. These cases took an average of 14 years from the earliest tax year audited until the most recent resolution in the courts, and they involved both U.S.- and foreign-controlled corporations. The cases illustrate how disputes over section 482 issues can become extremely expensive for taxpayers and the government by requiring the employment of outside experts, resulting in long, drawn out litigation and keeping corporate tax liabilities in an uncertain status for years.

IRS lost a significant section 482 issue for each of the five corporations. For example, courts have found that IRS abused its discretion under section 482 and that IRS' reallocation of income was unwarranted or arbitrary, capricious, and unreasonable.

Table 5: Summary of Corporations With Major Section 482 Court Cases Decided Between January 1, 1990, and December 31, 1992

Name	Date of returns studied	Date of ruling	Tax amount at issue (in millions)	Winner and ruling
Bausch & Lomb, Inc.	1979-81	1991	$9	Mixed--According to the appellate court, IRS' reallocation was unreasonable, and the Tax Court's reduction of the reallocation was appropriate, although some reallocation was permitted.
Merck & Co., Inc.	1975-76	1991	$5	Taxpayer--IRS' reallocation of income was arbitrary, capricious, and unreasonable.
Sundstrand Corp. (2 cases)	1977-80	1991-2	$50	Mixed--IRS abused discretion under section 482, and adjustments were unreasonable. Royalty was not arm's length. Taxpayer did owe some money. Issues decided in first case could not be relitigated.
Procter & Gamble Co.	1978-79	1992	$2	Taxpayer--Section 482 allocation was unwarranted. According to the appellate court, income distortion resulted from Spanish law, not from control by the parent.
Westreco, Inc.	1978-82	1992	$9	Taxpayer--IRS abused discretion; fees reflected income.

Note: We selected the five cases from Tax Notes indexes by picking those that were decided between January 1, 1990, and December 31, 1992, and involved what we considered to be a major section 482 reallocation issue.

Source: Tax Notes and court cases.

IRS' USE OF CERTAIN PROCEDURAL TOOLS HAS VARIED; THEIR ULTIMATE IMPACT IS STILL UNKNOWN

IRS has used certain new and existing procedural tools--designated summonses, formal document requests, advance pricing agreements, additional penalties, simultaneous examinations, and arbitration--to varying degrees. For most of them, we found that it is too soon to tell what their impact will be.

Designated Summonses and Formal Document Requests

IRS issued three designated summonses for transfer pricing cases in fiscal years 1991 and 1992. Sanctioned by Congress in 1990, designated summonses are summonses issued by IRS to suspend the running of the statute of limitations governing the time IRS has for assessing additional taxes against a taxpayer. According to an IRS official, the low number issued is the result of taxpayers, under new record-keeping requirements, cooperating more in providing documentation to examiners, precluding the need for tougher enforcement action.

This is the same reason given for the drop in formal document requests issued by IRS. These requests are issued when relevant taxpayer documents are outside the United States. The number of

requests issued to foreign- and U.S.-controlled corporations declined from 28 in fiscal year 1991 to 13 in fiscal year 1992.

Advance Pricing Agreements

Since we completed our report last year, IRS has gone farther down the road of advance pricing agreements, or agreements in which IRS approves ahead of time the methodology a taxpayer will use in setting transfer prices. As of March 5, 1993, IRS had completed 9 advance pricing agreements and was in negotiation on another 45 cases. These agreements are intended to reduce the contentiousness over transfer pricing that might have arisen with these companies and to save IRS audit time in future years. However, as IRS testified last year, if it reaches its goal of 75 advance pricing agreements per year, it will be spending 90,000 to 120,000 staff hours per year on them.

If the voluntary agreement covers only a small percentage of the taxpayers with international activity, the bulk of section 482 audits would still have to be made under possibly adverse, contentious conditions for IRS. If, however, the advance pricing agreements become extremely popular and cover a much larger number of taxpayers, IRS will have to adjust its resources to accommodate them.

Additional Penalties

Section 6662 of the Internal Revenue Code--as modified in 1990--imposes substantial penalties on tax underpayments attributable to certain section 482 allocations that were substantially misstated. However, the penalties have not been used yet. According to the administration's revenue proposals,[10] this is due, in part, to the law not defining exclusions applying to taxpayers who acted in good faith and had reasonable cause for determining their transfer prices.

The administration's revenue proposals would amend section 6662(e) to define the reasonable cause and good faith exclusion. To meet the exclusion, the taxpayer would have to provide contemporaneous documentation showing the use of one or more reasonable transfer pricing methodologies on the taxpayer's controlled transactions.

According to the administration proposals, once the exclusion definition is enacted, compliance should improve. The substantial penalty will give taxpayers a strong incentive to apply and document a methodology leading to an arm's length result. Also, the administration believes that the documentation required would enhance examination effectiveness. Instead of

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[10]Department of the Treasury, Summary of the Administration's Revenue Proposals (Feb. 1993).

devoting resources to identifying transfer pricing issues and developing comparable data to support a methodology, examiners would be able to focus immediately on the methodology's validity and on the taxpayer's supporting data.

Simultaneous Examinations

In simultaneous examinations, the United States and another country at the same time examine related parties under their jurisdictions in an effort to promote international tax compliance and information exchange. Thirty-three of these examinations were proposed in fiscal years 1991 and 1992, a much higher number than that proposed in previous years. However, in those two fiscal years, only nine simultaneous examinations were accepted--all in 1992--for follow through.

For years, at least since our 1981 report on transfer pricing,[11] IRS has emphasized the importance of its simultaneous examination program to protect U.S. interests in international tax enforcement. However, according to IRS and foreign officials, problems such as differences in language and audit periods have existed and we believe these problems would keep the number of examinations relatively modest.

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[11] IRS Could Better Protect U.S. Tax Interests in Determining the Income of U.S. Multinational Corporations (GAO/GGD-81-81, Sept. 30, 1981).

Arbitration

In our June 15, 1992, report we stated that, according to IRS officials, Tax Court Rule 124, covering voluntary binding arbitration, had not yet been used much in general or in section 482 cases. Under this rule, any time a factual case is at issue and before trial, the parties to the case may move to resolve it through voluntary binding arbitration. IRS had begun promoting arbitration at the time of our report, but to date only one transfer pricing arbitration case has been scheduled. Other taxpayers may be awaiting the outcome of this case.

In summary, because of IRS' limited experience with such tools as arbitration, simultaneous examinations, substantial valuation penalties related to section 482, and advance pricing agreements, it is too soon to tell what their eventual impact will be.

CHALLENGES OF SECTION 482
WILL CONTINUE

The challenges of section 482 cases will continue because the growing internationalization of the U.S. economy will increase the potential for underpayment of U.S. taxes through transfer pricing practices of multinational enterprises. In addition, the arm's length standard will continue to be difficult for IRS to enforce.

Growing Internationalization of the U.S. Economy

The U.S. economy has been increasingly influenced by international forces in the last 30 years. This influence has been demonstrated by the growing amount of merchandise trade between affiliated corporations and our dependence on foreign trade and foreign investments. For example, merchandise exports of U.S. parent companies to their foreign affiliates increased from $6 billion in 1966 to $86 billion in 1989 and represented 24 percent of total U.S. merchandise exports in 1989. Merchandise imports by U.S. parent companies from their foreign affiliates increased from $4 billion in 1966 to $72 billion in 1989 and represented 15 percent of U.S. merchandise imports in 1989.

The growing internationalization of the U.S. economy poses a major challenge for IRS because the potential for underpayment of U.S. taxes increases with the number of transactions done among affiliates of foreign- and U.S.-controlled multinationals. While we do not know the exact number of such transactions, we know that the number of affiliates has increased in recent years. For example, of the 7,500 largest foreign corporations controlled by U.S. corporations, an average of 237 firms per year were incorporated from 1980 through the first half of 1989. Also, the number of returns of foreign-controlled corporations increased 22 percent, from about 37,000 for the 1984-to-1986 period to about 45,000 returns for the period 1987 to 1989.

Problems That Have Existed With Arm's Length Pricing

As indicated in our June 1992 report, the arm's length standard requires that the price charged on a transaction between related corporations be the price that would have been charged if the corporations had been unrelated. To enforce this standard, IRS must analyze comparable transactions between unrelated corporations to identify an arm's length price that the related corporations must charge. If IRS finds a difference between the arm's length price and the price that the related corporations charge, it can propose an adjustment to the related corporations' income.

Under the current regulations, IRS and taxpayers use direct and indirect methods for identifying arm's length prices. The comparable uncontrolled price method is based on a direct comparison of the prices charged on readily identifiable, comparable transactions between unrelated parties. More indirect methods, such as the resale price, cost plus, and other appropriate methods, base prices on comparisons with unrelated corporations performing similar functions. All of these methods may require IRS examiners to use considerable judgment and to develop and analyze a great deal of data. The indirect methods require a greater degree of judgment and data analysis.

A major obstacle in enforcing the arm's length standard has been the difficulty that IRS examiners have had in finding readily identifiable, comparable transactions. In the absence of such comparables, they have relied on the more subjective, indirect methods to find transfer prices. Several studies, listed in table I.3 in appendix I, showed that these indirect methods were used for most section 482 cases. The data requirements and the subjective nature of the pricing methods imposed a significant administrative burden on both corporate taxpayers and IRS and created uncertainty for corporations about their ultimate tax liabilities.

Impact of New Section 482 Regulations Is Uncertain

On January 21, 1993, IRS' temporary regulations on intercompany transfer pricing were published. The temporary regulations are for tax years beginning after April 21, 1993. The regulations provide guidance on the factors that need to be considered when determining appropriate comparable transactions, but the task itself remains based on facts and circumstances. The regulations may ease IRS' enforcement problems by requiring increased documentation of taxpayers' transfer pricing methods.

Also, the revised regulations provide more flexibility to taxpayers in selecting their transfer pricing methods. A new "best method" approach allows the method to be chosen that gives

the most accurate result under the arm's length standard given the facts and circumstances of each transaction.

However, because the "best method" approach is based on the facts and circumstances of each case, the task of selecting and justifying transfer prices will remain complex and open to interpretation. As we said in our June 1992 report, transfer pricing problems will not be solved soon because of the fact-sensitive nature of the cases. Also, the difficulty of finding comparable transactions will remain for many intangible properties. The new regulations provide less guidance for transactions involving intangibles than for transactions involving other types of property.

On the positive side, the additional guidance on determining comparable transactions and the recognition that a range of prices rather than a single arm's length price may exist should reduce the uncertainty that taxpayers face under the current regulations. Taxpayers with prices within the arm's length range will be protected to some degree from small changes in transfer prices by IRS that result in large increases in tax liabilities. IRS may still make periodic adjustments to the charge for intangible property to meet the commensurate with income standard.[12]

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[12]The Tax Reform Act of 1986 amended section 482 to require that payments for intangible properties transferred or licensed to related parties be "commensurate

Increased documentation requirements may also ease IRS' enforcement burden. The requirement for contemporaneous documented support for transfer pricing methods provides IRS with information for detecting abuse and evasion. The requirements may add to the compliance burden of taxpayers to the extent that transactions will be documented whether or not they are at issue with IRS. However, contemporaneous documentation will be useful to taxpayers in justifying their prices and in avoiding substantial misstatement penalties.

Although we expect problems with the arm's length standard to continue, we also recognize the difficulty of changing the standard. Because the arm's length standard is considered to be the international norm, any change would have to be coordinated with U.S. tax treaty partners in order to avoid double taxation of U.S. corporations. Such coordination is likely to be difficult and time-consuming.

In conclusion, although IRS has developed new regulations and begun to expand its use of certain tools for dealing with section 482 cases, we do not believe the end of the transfer pricing challenge is yet in sight. The problem is large in terms of the dollar amounts at stake, and the potential for underpayment of U.S. taxes is growing along with the growing internationalization of the U.S. economy. It is important, therefore, that IRS

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with the income attributable to the intangible."

implement its managerial initiatives and continue to monitor the effectiveness of the regulations and its transfer pricing tools.

That concludes my statement. I would be pleased to respond to any questions.

APPENDIX I

FOREIGN- AND U.S.-CONTROLLED CORPORATIONS THAT PAID OR DID NOT PAY U.S. INCOME TAX IN 1989

Table I.1: Foreign- and U.S.-Controlled Corporations That Did Not Pay U.S. Income Taxes, 1989

Distribution by asset size	Foreign-controlled corporations (FCC)		U.S.-controlled corporations (USCC)	
Returns	Number	Percent of all FCCs	Number	Percent of all USCCs
Less than $10 million	29,781	66.4	1,251,643	58.2
$10 million under $100 million	1,909	4.3	11,158	0.5
$100 million under $250 million	238	0.5	1,614	0.1
$250 million or over	207	0.5	1,555	0.1
Total	32,135	71.7	1,265,970	58.9
Receipts	Millions	Percent of FCCs' receipts	Millions	Percent of USCCs' receipts
Less than $10 million	$27,790	2.9	$764,596	9.2
$10 million under $100 million	49,763	5.1	211,246	2.5
$100 million under $250 million	30,450	3.1	85,101	1.0
$250 million or over	94,956	9.8	341,620	4.1
Total	$202,959	21.0	$1,402,563	16.9
Assets	Millions	Percent of FCCs' assets	Millions	Percent of USCCs' assets
Less than $10 million	$27,022	1.9	$335,114	2.2
$10 million under $100 million	56,099	3.9	339,521	2.2
$100 million under $250 million	38,530	2.6	252,339	1.7
$250 million or over	243,226	17.0	1,904,803	12.5
Total	$362,878	25.4	$2,831,776	18.5

Note 1: Totals may not add due to rounding.
Note 2: Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Source: IRS data.

Table I.2: Foreign- and U.S.-Controlled Corporations That Paid Income Taxes, 1989

Distribution by asset size	Foreign-controlled corporations (FCC)		U.S.-controlled corporations (USCC)	
Returns	Number	Percent of all FCCs	Number	Percent of all USCCs
Less than $10 million	10,057	22.4	858,505	39.9
$10 million under $100 million	1,795	4.0	18,916	0.9
$100 million under $250 million	366	0.8	3,138	0.1
$250 million or over	486	1.1	3,095	0.1
Total	12,704	28.3	883,654	41.1
Receipts	Millions	Percent of FCCs' receipts	Millions	Percent of USCCs' receipts
Less than $10 million	$31,283	3.2	$1,230,622	14.8
$10 million under $100 million	81,896	8.5	621,793	7.5
$100 million under $250 million	66,653	6.9	335,044	4.0
$250 million or over	584,329	60.4	4,705,449	56.7
Total	$764,162	79.0	$6,892,907	83.1
Assets	Millions	Percent of FCCs' assets	Millions	Percent of USCCs' assets
Less than $10 million	$14,471	1.0	$446,326	2.9
$10 million under $100 million	58,284	4.1	624,661	4.1
$100 million under $250 million	57,869	4.0	487,149	3.2
$250 million or over	935,649	65.5	10,892,026	71.3
Total	$1,066,272	74.6	$12,450,164	81.5
Taxes	Millions	Percent of FCCs' taxes	Millions	Percent of USCCs' taxes
Less than $10 million	$526	8.5	$10,189	11.6
$10 million under $100 million	912	14.8	8,260	9.4
$100 million under $250 million	530	8.6	5,048	5.7
$250 million or over	4,193	68.1	64,434	73.3
Total	$6,161	100.0	$87,931	100.0

Note 1: Totals may not add due to rounding.

Note 2: Figures were derived from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Note 3: Table provides information about companies that paid tax. Percentages reported in both tables are based on the total amount of returns, receipts, assets, and taxes paid by all corporations in each group.

Source: IRS data.

METHODS USED IN TRANSFER PRICING CASES

Table I.3: Percentage of Cases in Which Various Section 482 Pricing Methods Were Used

Report or survey	CUP[a]	Resale	Cost plus	Other
1973 Treasury report	21%	11%	27%	41%
1972 Conference Board report	28%	13%	23%	36%
1980 Burns report	24%	14%	30%	32%
1981 GAO report (tangible property)	15%	12%	26%	47%
1984 IRS survey	41%	7%	7%	45%
1987 IRS survey (overall)	32%	8%	24%	36%
1987 IRS survey (tangible property)	31%	18%	37%	14%

[a]Comparable uncontrolled prices.

Sources: A Study of Intercompany Pricing (White Paper), Treasury Department (Oct. 18, 1988); and IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (GAO/GGD-81-81, Sept. 30, 1981).

(268602)

Statement of Dan R. Bucks

Multistate Tax Commission

Mr. Chairman, Members of the Committee, thank you for the opportunity to testify today. I am Dan Bucks, Executive Director of the Multistate Tax Commission. The Commission is an interstate organization representing 33 states.[1] One of the Commission's major activities is developing fair, effective, and administrable methods of dividing, for state tax purposes, the income of businesses operating across state and national government boundaries. We also audit major multinational corporations for state income tax purposes, and have been doing so for more than 20 years. Thus, we have a great deal of experience, grounded in the real world of day-to-day tax administration, with the issues raised by today's hearing.

I want to commend you, Senator Dorgan, for initiating this hearing, which is directed at one of the great and unfortunate federal policy failures of the last 30 years: the failure to ensure a fair and proper reporting, for tax purposes, of income earned by multinational corporations within the United States. As a former state tax commissioner and as a former Chair of the Multistate Tax Commission, you understand this problem thoroughly, and we appreciate greatly your leadership in focusing new light on it.

My message today is that the federal government's approach to dividing and taxing the income of global corporations is doomed to fail and that, in effect, the emperor has no clothes and is in serious need of being saved from his own embarrassment. The federal government is wearing an imaginary suit of clothes called "arm's-length pricing adjustments." The arm's-length pricing method is largely unworkable, and wastes scarce federal tax enforcement resources. For the multinational business that does diligently attempt to determine arm's length prices, it demands an enormous expenditure of resources as well. Worst of all, it fails to produce the tax revenue that it is intended to generate, and it causes real economic harm, by shifting the tax burden unfairly to small U.S. businesses that are the main engines of job growth in America.

Why are state government representatives concerned about the transfer pricing issue? Very simply, because for every dollar that the federal government loses because of improper transfer prices, states—whose tax systems are now largely tied to the federal determination of U.S.-source income—lose 22 cents.[2] If the federal government is losing $10-12 billion annually, as President Clinton suggested during the campaign,[3] the states are losing an additional $2-2.5 billion. This brings the combined government revenue losses from transfer pricing to $15 billion annually.

The Commission shares President Clinton's and this Committee's concern that improper transfer prices are causing a serious drain on the federal treasury. MTC staff research suggests that $10-12 billion in annual losses is a realistic, if not conservative, estimate. Looking at just one category of transactions by one group of multinational businesses illustrates this. IRS data have consistently shown that foreign-owned wholesalers and retailers—many of which act as distributors for affiliated foreign manufacturers—pay considerably more for the goods they resell than do U.S.-owned wholesalers and retailers. If they had had the 76 percent cost-of-goods

sold to sales ratio of their U.S.-owned competitors rather than the 85 percent rate they reported,[4] their 1989 taxable incomes would have been $35 billion higher. All other things equal, they would have paid $12 billion more in tax at the statutory 34 percent tax rate. Just this simple "back-of-the-envelope" calculation addressing just one category of multinational corporations can, in other words, suggest an annual revenue loss attributable to transfer pricing that is very close to President Clinton's campaign estimates.

Another way that a $10-12 billion annual revenue loss can be substantiated is by comparing it to the total volume of transactions between related corporations that cross the U.S. border each year. A conservative estimate involving some extrapolation of IRS data is $350 billion.[5] At this volume, transfer prices that are "off" on average by just 10 percent would again lead to an understatement of U.S. taxable income of $35 billion and underpayment of tax of $12 billion. This is not to assert that this is the average variance of actual transfer prices from "arm's-length" prices. It is not an implausible variation, however, given that penalties do not even potentially apply until inbound transfer prices are 100 percent too high and outbound transfer prices are 50 percent too low. It is also plausible that taxpayers would take an "aggressive" transfer pricing position to the extent of a 10 percent variance when there is no certainty concerning the true "arm's-length" price in any case and when the IRS has had such little success at sustaining its transfer price adjustments when they are appealed and litigated.

Revenue losses of this magnitude provide clear evidence that the arm's length system has failed. Why has it failed? Because it attempts to do the impossible. It tries to regulate the prices for every category of product, service or intangible asset exchanged between related, jointly owned and controlled corporations. There are more than 46,000 global corporations doing business in the U.S. that operate with and through affiliated corporations in foreign countries.[6] As previously noted, these corporations engage in $350 billion of transactions within their own family of related corporations in foreign nations every year. This amount of controlled trade represents millions of transactions, and the amount of resources required to audit and adjust the prices for this volume of trade is overwhelming and well beyond even the recently expanded resources of the IRS.

Beyond the sheer volume of controlled transactions, there is the more fundamental problem that the arm's-length pricing method assumes an economic world that does not exist. Trade among jointly owned corporations is not, by definition, arm's-length, free market trade. So the IRS must attempt to discover free market prices for comparable transactions as a standard to adjust the prices in the controlled trade situation. The problem is that for major global industries—such as pharmaceuticals, automobiles, financial services, and electronics—there are frequently no international free market transactions to compare with the controlled trade among affiliated companies.

The fundamental problem of the absence of comparable uncontrolled transactions is well-illustrated by one of the famous cases the IRS lost: the Bausch & Lomb case. Bausch & Lomb licensed the use of a patent on a unique manufacturing process for soft contact lenses to its Irish subsidiary. The principal tax dispute was over whether or not the amount of royalty paid by the Irish subsidiary to its parent was sufficient. The IRS tried to raise the royalty price being paid, but the problem is that there is no free market for patents in soft contact lens manufacturing processes. Absent a free market for this asset, the IRS could not prove that its assessment was correct. The case deteriorated, as most such cases do, into a debate over a range of prices, any one of which could be used because there is no single right answer.

Worse yet, unlike the typical case in which a taxpayer has the burden of proof to justify his or her method of reporting income, in the arm's-length world, the IRS, for all practical purposes, must shoulder the burden of proof. The IRS must prove, not only that the taxpayer's reported prices are incorrect, but what the correct prices are. Again, in the big-dollar cases involving valuable intangible assets, this is an impossible task, because free market prices necessary for the IRS to prove the taxpayer wrong often do not exist.

Even in more routine cases involving widely sold consumer products, like VCRs or motorcycles, very complicated and subjective adjustments for "volume discounts", "location savings", "market risks", "market penetration strategies", and other economically relevant factors may have to be made. But every such adjustment adds a potentially disputable issue, and any number of prices within a broad range may end up being correct. Because the burden of proof has effectively been turned on its head, the global taxpayer has wide discretion to report what it wishes to various national tax authorities. The arm's-length system thus fails the first test of a tax system, namely that it be mandatory. Because it is based on a false economic premise and is flawed by a misplaced burden of proof, the arm's-length method is more like a voluntary contribution system than a real system of taxation.

The American states confronted the fundamental issues involved in dividing the income of multijurisdictional corporations much earlier than the federal government, because there was significant interstate commerce between related corporations long before there was significant international commerce. The states recognized very early on the practical impossibility of preventing improper income shifting on a transaction-by-transaction basis.

More importantly, the states recognized the full range of economic synergies involved in being an integrated economic enterprise that make it theoretically impossible to identify where profit is earned. Jointly owned and controlled corporations that operate together on a global basis benefit from economies of scale, the ability to minimize risk, and the fact that technical expertise and information can

often be obtained more cost effectively when it is fixed in the minds of employees than when it has to be purchased on the open market. These kinds of efficiencies generate value for the whole enterprise that is greater than the sum of the parts, and it is this value that cannot meaningfully be divided among separate legal entities as the arm's-length system attempts to do. In choosing formula apportionment of the combined income of all the members constituting an integrated economic enterprise over the current separate entity, arm's-length, transactional approach, the states were thus choosing a system that the "economic theory of the multinational firm" is only now catching up to. Formula apportionment is the method of tax accounting that best fits the economic reality of world trade conducted within global enterprises. It should also be emphasized that formula apportionment is a mandatory taxpayer reporting system, not an after-the-fact income reallocation system like Section 482.

A growing number of international tax experts have either flatly endorsed substituting a combined reporting formula apportionment system for the current arm's length system, or suggested that the option be seriously considered. Among these experts are Ronald Pearlman, former staff director of the Joint Committee on Taxation, economist Lawrence Summers, President Clinton's nominee to be Undersecretary of the Treasury for International Affairs, and attorneys Stanley Langbein, Michael McIntyre, Louis Kauder, Dale Wickham, and Charles Kerester.[7]

Under a combined reporting, formula apportionment system, the legal entities comprising a distinct and integrated economic enterprise are first identified. For example, if a group of commonly owned corporations is really engaged in two separate businesses, say, steel manufacturing and a department store chain, and there are no significant economic ties between the two businesses, then the income of the two separate businesses is apportioned separately.

Next, the combined income of the business is determined in a manner similar to the calculation of federal consolidated income, with the key factor being the elimination of intercompany transactions. Returning to the example, assume that the parent company of the department stores is a wholesaler. Further assume that it purchases all inventory from unrelated suppliers. It then resells most of the inventory to the related department stores incorporated separately in each state, and some of it to unrelated department stores. In this case, the charges from the wholesaler to the related retail stores would be eliminated. The business' combined income would be calculated by taking the total of the department stores' retail sales and the wholesaler's sales to independent department stores, and subtracting from it the wholesaler's inventory purchases and all other expenses paid by both the wholesaler and its related department stores to unrelated suppliers (e.g., rent, interest, wages).

Finally, the combined income is apportioned to each state with legal jurisdiction to tax a share of it in proportion to objective measures of the activities

engaged in by the business in each state. The most commonly-used measures are property, payroll, and sales, and the apportionment is usually done on an equally weighted basis. Thus, if 10 percent of the business' sales to outsiders occurred in State A and 10 percent of its payroll and property were located there, State A would be able to tax 10 percent of the business' combined income.

California, Montana, North Dakota, and Alaska continue to require multinational businesses to do this combination and apportionment on a global basis (although they generally permit an election to include only corporations incorporated in or with most of their business in the United States). The federal government could adopt the same global apportionment system and thereby eliminate any need to examine or indeed worry about intercompany transfer prices.

As in all tax systems, there are complexities that have to be dealt with and policy choices that must be made. For example, an overall functional examination of a multinational corporate group needs to be conducted to determine whether it is engaged in one or multiple lines of business, and, if the latter, to determine which subsidiaries are involved in which business. But this is a far simpler matter than engaging in a functional analysis for transfer pricing purposes, which may require not only the determination, but also precise measurement, of which of two parties to a particular transaction contributed which assets, incurred which expenses, and bore which risks. The inevitable conclusion is that the range of potential controversies between taxpayers and tax authorities is exponentially larger under a transaction-based transfer pricing enforcement system than it is under formula apportionment.

Many "red herrings" are pulled out of the barrel when a federal apportionment option is discussed. Addressing the objections raised to formula apportionment is beyond the scope of this hearing. To give one example, however, it should be clear that is far simpler to translate into dollars the annual net income of an entire subsidiary than it is to determine which of two parties in a cross-border transaction is actually bearing foreign exchange risk and then to value this for pricing purposes.

From the standpoint of the resources required to enforce it effectively, formula apportionment is far superior to a system based on adjusting transfer prices. A comparison of the amount of staff time required by the federal arm's length method and formula apportionment is shown on the chart accompanying this statement. The federal government spends at least three to seven times as many staff hours completing an international arm's length audit that may cover only a small portion of a company's related-party transactions as compared to the hours the states spend on an international formula apportionment audit that covers all international issues. This comparison actually understates the greater efficiency of the states' approach, because a "best case" scenario for arm's-length reported in a joint 1992 Treasury/IRS report[8] is being compared to the "worst case" scenario of the states. The 2100 hours of staff time per audit is the lower of two examples reported by the IRS (the other

case entailed 5000 hours), and one that concerned "only a limited portion of the taxpayer's cross border transactions."[9] In contrast, the 300 to 700 hours of state staff time are high numbers for the states because they are estimates for the first audits of a multinational corporate group, and subsequent audits take one-third to one-half less time. Even in the case of the streamlined "Advanced Pricing Agreement" procedure, where the IRS works out an advanced settlement with a willing, cooperative taxpayer, the federal government spends 2 to 5 times the staff hours as the states do on their audits.[10]

Does using three to seven times as much staff time as the states yield better results? Sadly, the answer is "no." The Internal Revenue Service has failed to sustain its transfer pricing adjustments in every major case it has taken to court in the last ten years. Losing badly in court, the IRS has turned to settling a large portion of transfer pricing cases, and in 1991 it settled those cases for an average 23 cents to 28 cents on the dollar.[11] These are not intended as criticisms of the IRS, for they have dedicated and talented staff working on these issues. The problem is that the arm's-length pricing system largely impedes success. The fault lies with the policy, not with the Service. But in comparison, the states have won the bulk of their international cases, and the U.S. Supreme Court has upheld the validity of their formula apportionment method.[12]

It should not be overlooked that states that are among the smallest in the nation, such as North Dakota and Montana, have succeeded in administering an international apportionment system when the federal government has failed to make arm's-length pricing work. Sadly, the Reagan Administration in the mid-1980's pressured these and other states to limit their use of international apportionment.

To summarize, the current arm's-length approach to international taxation loses the federal and state governments a conservatively estimated $15 billion a year, shifts that cost unfairly to ordinary taxpayers and small businesses, and costs the federal government three to seven times the staff resources as compared to the more efficient and more effective state system of formula apportionment. It is an approach under which the IRS has not been able to win a major court case in recent times, and it must settle other cases for a minor fraction of the original assessments. It is an approach that is doomed to fail because of the volume of transactions that must be reviewed and corrected and, more fundamentally, because the approach does not fit with the economic reality of the global marketplace.

Why do we stick with a method that has failed so badly for nearly 30 years? The reason given time and again by Treasury officials is that the "Devil makes us do it." Who is the Devil in this case? International tax treaties. But is this a reasonable answer? No treaty and no law should require anyone to do that which is impossible. If they do, they should be changed. Further, the major treaties do not speak of adjusting prices to an arm's-length level. In fact, the treaties speak of

adjusting profits in a manner that achieves arm's-length results.[13] Treasury could, if it so decided and without revising the treaties, explore with other treaty partners developing formula apportionment processes that adjust profits instead of prices.[14] Indeed, one can argue that Treasury has precisely a responsibility to do just that. Thirty years ago, the U.S. government led its trading partners down the arm's-length pricing path. We now know that path has reached a dead end, and it is time for the U.S. government, through Treasury, to lead its trading partners down a new path of dividing profits through formula apportionment.

Mr. Chairman and Members of the committee, we believe that in continuing to seek cover from transfer pricing problems in Section 482, the federal government is in fact parading naked in the international tax arena. It is time for this emperor to get a suit of clothes. He will not find a good suit of clothes in London, Brussels, Berlin or Tokyo, and he will certainly not find them in the Cayman Islands or Netherlands Antilles. The emperor will find a good suit of clothes in Sacramento, Salem, Helena, Boise and Bismarck—and when he finds this suit of clothes, he will discover that they fit well, are a good value for the money, and will last a long, long time.

ENDNOTES

1. The Member States of the Multistate Tax Commission are Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington.

   The Associate Member States are Alabama, Arizona, Connecticut, Georgia, Louisiana, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, Ohio, Pennsylvania, Tennessee, and West Virginia.

2. Multistate Tax Commission staff estimate based on a calculation of the weighted average state statutory corporate income tax rate as a percentage of the federal statutory rate.

3. Governor Bill Clinton, Putting People First. A National Economic Strategy for America, p. 22. The revenue to be gained by stepped-up enforcement of Section 482 is estimated there as growing from $9.0 billion in 1993 to $13.5 billion in 1997. The four-year average is $11.3 billion.

4. James R. Hobbs, "Domestic Corporations Controlled by Foreign Persons, 1989," Statistics of Income Bulletin, Winter 1992-93, p. 12, Figure F.

5. With regard to U.S. subsidiaries of foreign parent multinationals, the IRS Statistics of Income Division has only compiled the data on transactions with related parties for the 121 foreign-controlled U.S. corporations with over $1 billion in sales. The IRS reports a total of $89 billion inbound and outbound transactions for this group of companies, exclusive of the principal amount of loans. See: James Hobbs and John Latzy, "Transactions Between Foreign Controlled Corporations and Related Foreign Persons, 1988, Data Release," Statistics of Income Bulletin, Summer 1992, p. 122. (We exclude the principal balance of loans from our measure of related party transactions, since only the interest charges on the loans would ordinarily be subject to a Section 482 adjustment). These 121 corporations, according to IRS, account for approximately half of the total sales of all foreign-controlled corporations. We assume that the untabulated corporations engage in related-party transactions to the same degree as the tabulated ones, and thus double the figures reported for the 121 corporations.

   With regard to U.S. based multinationals, the IRS has compiled data only for the 744 with more than $500 million in assets. See, John Latzy and Randy Miller, "Controlled Foreign Corporations, 1988," Statistics of Income Bulletin, Fall 1992, p. 71. This article (at p. 66) reports $143 billion in related party sales of "stock in trade" with 7500 foreign subsidiaries. Unpublished data compiled for the Multistate Tax Commission by the Statistics of Income Division counts an additional $33 billion in related party sales of services, royalties, interest, etc. Since the IRS reports that the 7500 foreign subsidiaries of these 744 U.S. parents account for fully 92 percent of the sales of all U.S. controlled foreign subsidiaries, we have not extrapolated the related party transactions upward.

6. There were 44,840 U.S. corporations controlled by foreign persons that filed 1989 tax returns. See: James R. Hobbs, "Domestic Corporations Controlled by Foreign Persons, 1989," Statistics of Income Bulletin, Winter 1992-93., p. 7. The IRS also reports that 750 U.S. corporations with assets over $500 million control 7500 foreign subsidiaries. See: John Latzy and Randy Miller, "Controlled Foreign Corporations, 1988", Statistics of Income Bulletin, Fall 1992, p. 71. However, this is by no means a complete count of U.S. based multinationals. A much more comprehensive compilation by the U.S. Commerce Department indicates that there are

actually more than 2000 U.S. based multinational corporations that own a majority interest in over 15,000 foreign subsidiaries. U.S. Dept. of Commerce, U.S. Direct Investment Abroad. 1989 Benchmark Survey, Final Results, October 1992, p. M-25. It is worthy of note that a listing by Treasury and IRS of Commerce Department data sources that could be of use in Section 482 enforcement completely omitted this extremely comprehensive survey of foreign direct investment and a comparable one covering investment in the U.S. by foreign multinational corporations. See, U.S. Department of Treasury and Internal Revenue Service, Report on the Application and Administration of Section 482, April 9, 1992, p. 5-15.

7. See: Kathleen Matthews, "Dolan, Pearlman Square Off Over Arm's-Length v. Formula Approach," Tax Notes, March 25, 1991, p. 1335; Lawrence H. Summers, "Taxation in a Small World," in Herbert Stein, ed., Tax Policy in the Twenty-First Century, (New York: John Wiley & Sons) 1988, p. 71; Stanley I. Langbein, "A Modified Fractional Apportionment Proposal for Tax Transfer Pricing," Tax Notes, February 10, 1992, pp. 719-730; Michael J. McIntyre, "Design of a National Formulary Apportionment Tax System," in Proceedings of the Eighty-Fourth Annual Conference of the National Tax Association-Tax Institute of America, 1991, pp. 118-124; Louis M. Kauder, "Intercompany Pricing and Section 482: A Proposal to Shift from Uncontrolled Comparables to Formulary Apportionment Now," Tax Notes, January 25, 1993, pp. 485-493; and Dale W. Wickham and Charles J. Kerester, "New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?" Tax Notes, July 20, 1992, pp. 339-361.

8. See: U.S. Department of Treasury and Internal Revenue Service, Report on the Application and Administration of Section 482, April 9, 1992, pp. 3-3, 3-4.

9. Ibid., p. 3-3.

10. "Results to date indicate that the anticipated average Service [staff] time to complete an APA case will be 1200-1600 hours." Ibid., p. 3-5. In our judgment, there may be no better indication of the inadministrability of the arm's-length system than the fact that the IRS expects to devote two-thirds of a staff-year to verify the pricing methodology of one completely cooperative taxpayer, valid for perhaps 2-3 tax years, covering perhaps only a small set of that taxpayer's transactions with related parties.

11. Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States, Hearing before the Subcommittee on Oversight, of the Committee on Ways and Means, House of Representatives, April 9, 1992, pp. 145-6.

12. This statement could be affected, however, by the outcome of a pending case, *Barclays Bank PLC v. Franchise Tax Board*, 2 Cal.4th 708(1992). California has prevailed through the California Supreme Court in this case, which involves a challenge to the constitutionality of the application of worldwide unitary combined reporting to a foreign parent corporation. Barclays Bank is seeking U.S. Supreme Court review of the case. In 1983, in the landmark *Container v. California* case, the U.S. Supreme Court upheld the constitutionality of worldwide unitary combined reporting as applied to U.S. based multinationals.

13. Article 9-1 of the U.S. Model Tax Treaty provides:

1. Where

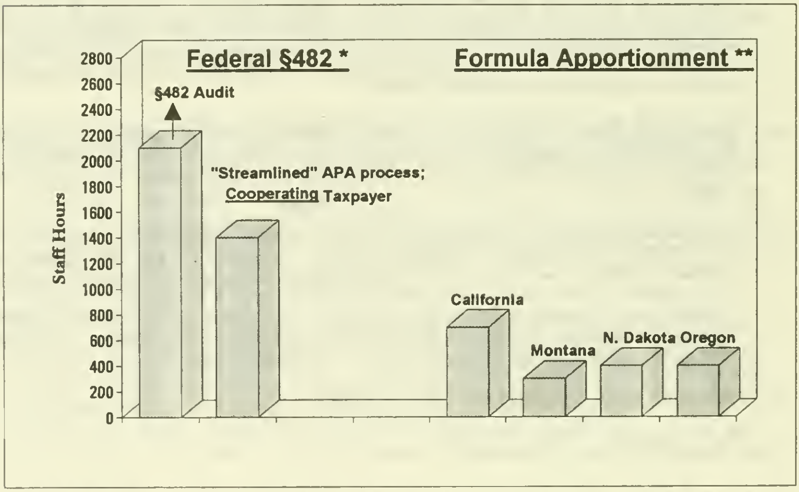
(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any **profits** which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the **profits** of that enterprise and taxed accordingly. **[Emphasis added]**

14. That Treasury itself believes that some forms of formula apportionment are consistent with arm's-length standard is indicated by the fact that at least one Advanced Pricing Agreement has used a formula approach. (U.S. Department of Treasury and Internal Revenue Service, Report on the Application and Administration of Section 482, April 9, 1992, p. 3-3). We would also argue that "profit splitting" sanctioned in proposed IRS Section 482 regulations issued in January 1993 is a form of formula apportionment. Indeed, one method authorized in these regulations, the "capital employed allocation rule," would be clearly recognized by state tax administrators as a "single-factor" apportionment formula using property as the factor.

Administrative Staffing Requirements:

Federal §482 vs. Global Formula Apportionment



* Audit or advanced approval of limited set of related-party transactions. Source: U.S. Treasury Dept and Internal Revenue Service, "Report on the Application and Administration of Section 482", April 1992, pp. 3-3, 3-4.

** First audit, covering three tax years, total tax liability. Subsequent audits generally require considerably fewer audit hours because facts to support determination of combined group have already been established. Source: Multistate Tax Commission Survey of State corporate audit directors.

APPENDIX

HOW BIG IS THE FEDERAL REVENUE LOSS FROM TRANSFER-PRICING? -- AN EVALUATION OF THE ARGUMENTS

Transfer prices charged on both "inbound" and "outbound" transactions may be subject to IRC §482 adjustments. An "inbound" transfer price is the price charged by a foreign corporation to a related U.S. corporation for the sale of tangible personal property or a service, the interest rate charged on a loan, the royalty charged for the use of a trademark or patent, etc.. An "outbound" transfer price is the converse, i.e., the charge by a U.S. corporation to a related foreign corporation. Inbound and outbound transfer prices refer to the direction of the charges, not whether the "parent" corporation is U.S.- or foreign owned. That is, U.S.- and foreign-owned parent corporations engage in both inbound and outbound transactions with their foreign subsidiaries, and all four categories may potentially be subject to §482 adjustments.

Estimates of the annual revenue loss to the Federal Government from just one side of the transfer pricing problem -- inaccurate or abusive transfer prices on both inbound and outbound transactions between U.S. subsidiaries and their foreign parent groups -- have ranged as high as $30 billion.[1] The $30 billion figure was reportedly based on imputing a 9 percent rate of return to the reported U.S. assets of foreign-owned U.S. corporations[2] , and the IRS has criticized it because its data show that U.S.-owned U.S. corporations themselves reported 1989 taxable income yielding only a 1.8 percent *pre-tax* return on assets.[3] Attributing half of the difference between this

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[1]*See Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means,* 101st Cong., 2d Sess. 226 (July 10 and 12, 1990) (Statement of the Hon. J.J. Pickle). For a discussion of the potential revenue losses associated with the foreign operations of U.S. based multinational corporations *see "Who Is Us?"--National Interests in an Age of Global Industry: Hearings Before the Joint Economic Committee,* 101st Cong., 2d Sess. 12 (Sept. 5 and 13, 1990) (Statement of Robert B. Reich, Professor of Political Economy, John F. Kennedy School of Government, Harvard University). *See also* Bucks, Dan R., *Will the Emperor Discover He Has No Clothes Before the Empire Is Sold?* 44 NAT. TAX J. 311 (September 1991). Data suggest that U.S. based multinational corporations report, for tax purposes, rates of return on foreign assets that are *ten times* as high as their rates of return on U.S. assets--suggesting a significant transfer pricing problem. *See,* Dworin, Lowell, *Transfer Pricing Issues,* 43 NAT. TAX J. 285 (September 1990). (Dworin is a Treasury Department economist).

[2] *See,* Matthews, Kathleen, *Just How Much Revenue Could the U.S. Raise by Beefing-Up Transfer-Pricing Enforcement,* 5 TAX NOTES INT'L. 914 (November 2, 1992).

[3] *See, Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws of Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means,* 102d Cong., 2d Sess. 104 (April 9, 1992) (Statement of Shirley Peterson, Commissioner of Internal Revenue))

1.8 percent rate of return and the 0.6 percent rate of return reported by foreign-owned corporations to inaccurate transfer prices[4] yields an estimate of a $3 billion annual revenue loss from transfer pricing involving foreign-owned U.S. corporations.[5]

However, the IRS data provide a flawed estimate of the actual returns that U.S. companies earn on their *U.S.* assets because the assets figure in the denominator includes the value of both U.S. corporations' investments in the stock of their foreign subsidiaries and the value of plant and equipment located in foreign branches.[6] In addition, the numerator, U.S. taxable income, is likely to be understated because of "outbound" transfer pricing by U.S.-based multinationals.[7] In sum, the IRS data likely understate the true rate of return that U.S.-owned corporations earn on their U.S. assets, with an unknown share of the understatement attributable to transfer pricing.

Data that has only recently been released by the IRS on *transactions* between foreign-owned U.S. corporations and their foreign affiliates[8] makes it possible to estimate the revenue loss attributable to assumptions about the magnitude of error in the transfer prices themselves. The data indicate that in 1988, the largest foreign-controlled U.S. corporations (those with at least $1 billion in receipts) had combined inbound and outbound transactions with their foreign affiliates totalling $89 billion.[9] These corporations represent approximately half of the total assets and receipts of all foreign-owned U.S. corporations; thus, it could reasonably be estimated that the combined inbound and outbound transactions of all foreign-owned U.S. corporations approximate $180 billion annually. An average 20 percent misreporting of their transfer

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[4] An econometric study coauthored by a Treasury Department economist had found that approximately half of the difference in the reported rates of return on assets of U.S.-owned and foreign-owned U.S. corporations could be explained by the theoretically supportable factors *other than* transfer pricing. *See,* H. Grubert, T. Goodspeed, and D. Swenson, Explaining the Low Taxable Income of Foreign-Controlled Companies in the United States (November 1991).

[5]*See Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws of Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means,* 102d Cong., 2d Sess. 100, 104 (April 9, 1992) (Statement of Shirley Peterson, Commissioner of Internal Revenue).

[6] MTC staff conversation with IRS Statistics of Income Division staff.

[7] *See,* Dworin, *supra,* Note 1. This transfer-pricing related understatement of income is offset to an unkown extent by the inclusion of foreign-source income.

[8]*Transactions Between Foreign Controlled Corporations and Related Foreign Persons, 1988,* 12 STATISTICS OF INCOME BULL. 119 (Summer 1992).

[9]*Id,* at 122. This figure is exclusive of the principal amount of loans, since this is not an income statement item. It does include interest on these loans, which is an income statement and tax return item potentially subject to a §482 adjustment.

prices to the detriment of U.S. taxable income would lead to a $12 billion revenue loss at the 34 percent statutory tax rate. This is not to assert that 20 percent is a reasonable estimate of the average variation from arms-length transfer prices for foreign owned U.S. corporations. The purpose of the example is to demonstrate that proportionately small adjustments can have significant revenue effects.

One other item of IRS data is suggestive of the potential magnitude of the revenue loss from transfer pricing involving foreign-owned U.S. corporations. Much of the concern has been directed toward the U.S. distributors of foreign manufacturers; indeed, this was the major focus of the Pickle Subcommittee hearings.[10] IRS data published for tax year 1988 reveal that the ratio of the "cost of sales and operations" (the major portion of which would be attributable to the cost of the goods sold) to total business receipts is nearly 10 percentage points higher for foreign-owned wholesalers/retailers than it is for U.S. distributors (85.6 percent versus 76.0 percent, respectively).[11] If foreign-owned distributors had the same ratio as their U.S.-owned counterparts, their deductions would have been $32 billion lower, and (all other things being equal) their taxable income correspondingly higher. At the statutory corporate tax rate of 34 percent, the revenue effect would be $11 billion.

In short, the data available from IRS compilations of tax return based data suggest that there is a measurable, statistically significant difference in the profitability of foreign-owned and U.S.-owned U.S. corporations. With the "back of the envelope" level of analysis that the data have thus far received, defensible estimates of the order of magnitude of the federal revenue losses associated with the transfer pricing practices of foreign multinationals alone range from the $3 billion that the IRS is willing to concede to the $11 billion figure just cited. These revenue losses are compounded by revenue losses at the state level, since state corporate income taxes are linked to federal definitions of U.S. source income. Since the weighted-average state corporate income tax rate is more than one-fifth of the federal corporate rate[12], the states will suffer an additional revenue loss approximating one-fifth of any federal revenue loss.

It is unconscionable that the data available to the federal government (including completely separate data sources on multinational corporations compiled by the Commerce Department) have received so little careful statistical analysis by federal government economists.[13] The Multistate Tax Commission respectfully urges that the new leadership of the Treasury Department place a high priority on mobilizing the tremendous expertise and data resources of the federal government toward the goal of elucidating and measuring the federal revenue losses from transfer pricing.

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[10] *Supra*, note 1.

[11] *See*, Hobbs, James, *Domestic Corporations Controlled by Foreign Persons, 1988*, 11 STATISTICS OF INCOME BULL. 83 (Fall, 1991).

[12] Multistate Tax Commission staff calculations.

[13] The Grubert/Goodspeed/Swenson study (*supra*, note 4) is the only statistical analysis that has ever been done to evaluate the IRS data. Moreover, the IRS has not even tabulated (much less analyzed) the data it has collected on the transactions with their foreign parents of foreign controlled U.S. corporations with less than $1 billion in sales (*see, supra* note 8).

IDAHO'S EXPERIENCE WITH IRC, SECTION 482

TESTIMONY OF PHILIP M. ALDAPE

Mr. Chairman and Members of the Committee:

My name is Phil Aldape. I am administrator of the audit & collections division of the Idaho State Tax Commission. For nearly 24 years I have served as a lead auditor or manager of the agency's multistate and multinational corporate income tax audit function. Over this period we have audited thousands of tax returns filed by many of the world's largest affiliated groups of corporations.

For most of this time we have used what is commonly known in corporate income taxation at the state level as the combined reporting method. This approach is used when the integrated business operations of commonly owned groups of corporations result in their functioning as a single "unitary" business enterprise whose activities cross state and national boundaries. Idaho, like all other states, is only able to tax the income of these businesses which is reasonably attributable to operations within the state. To accomplish this, we use a standard three factor formula to compute how much of the total income or losses of the unitary business from all sources is related to activities within Idaho. This formula determines the Idaho percentage of total property, payroll, and receipts for the entire corporate group and averages these individual percentages to approximate the portion of its business which is conducted within the state. This Idaho percent of total business activity, commonly known as the apportionment factor, is multiplied by the total net income or loss of the corporate group to determine its income or loss which is taxable by Idaho.

We have had one significant experience with use of Section 482 of the Internal Revenue Code. It involved a transfer of 100% of the stock of a company with substantial oil and gas

properties. This stock, which was owned by an Idaho company, was transferred to its parent holding company whose operations were entirely outside the state. Since an earlier unrelated agreement between the Tax Commission and the Idaho corporation required that its income be determined for the year in question based upon the separate entity filing of the Idaho corporation, combined reporting could not be used. Using a separate entity approach, the Idaho corporation should have determined and reported a gain from the transfer of this stock to its parent. We relied upon IRC Section 482 to support our finding that a gain on this transfer of stock should have been reported to reflect the difference between the fair market value on the date of the transfer and the basis of the stock on the books of the Idaho corporation. Determining the fair market value of this stock became the primary issue in the audit because the transfer did not occur at arm's length between unrelated entities. We found several conflicting sources of information within the taxpayer's records which further confused our attempts to determine the fair market value of various oil and gas properties held and operated by the corporation whose stock was transferred. Members of our staff spent weeks gathering and studying a number of authoritative industry publications on the valuation of mineral properties. Using two distinct valuation approaches, our property tax staff appraisers worked with the auditors to determine the value of the assets of the corporation whose stock was transferred. The first of these was performed by a CPA on our audit staff. He was one of the two auditors who worked on this case. His appraisal was based upon comparable sales of stock of similar corporations. Our second appraisal, which was performed by two Senior property appraisers in our ad valorem and estate tax units, concentrated on determining the value of the proven

and probable petroleum reserves of the company whose stock was transferred. These appraisals determined fair market values which resulted in a taxable gain ranging between $14,000,000 and $16,000,000 from the transfer of this stock. Even though nothing was originally reported on this transaction, the taxpayer conceded a taxable gain of approximately $8,000,000 after completing its own appraisal of the property.

This case was ultimately settled by compromise as preparations for litigation were being made. If it had not been resolved, we were planning to hire expert appraisers of oil and gas properties to perform their own valuation determinations and to provide expert testimony to support our case before the courts. We would likely have been required to spend $50,000 to $75,000 on this outside expert as well as the additional staff time and expense which is typically required when complex litigation such as this is presented to the courts. Ultimately, as our experience has shown is commonly true with questions of valuation, it would have come down to a judgment call as to whose witnesses were the most credible. For this reason, the appraisals which were performed by our staff would likely have been of little value since they would have been compared to those of the taxpayer which were done by industry specialists. Herein lies a key fallacy in having to use a valuation analysis such as that required by the arm's length method. To have a reasonable chance of sustaining a case, either the taxpayer or the audit staff must typically use an industry or other expert to support the values determined.

As it was, we spent an estimated 2,000 hours of staff time spread over the five years which elapsed from the date the taxpayer was contacted to schedule the examination until the case was settled. This compares to the average 200 hours we typically spend on a complex

combined reporting audit. If the combined reporting approach had been used in this case, the intercompany transfer of stock would have been eliminated. There would have been no need for determining the fair market value of the stock or the underlying oil and gas properties because there would have been no taxable gain on the transfer. Instead, Idaho would have been able to recognize its share of the income from these properties and any gain which might have arisen from the sale of the stock or underlying properties to unrelated third parties through use of the combined reporting approach in years when such income was recognized.

Since this audit was completed, members of our audit staff, including one of the two who worked on this case, spent another two weeks in training presented by IRS international examiners on the basics of using Section 482 for arm's length pricing audits. In this training, we learned that just the audit work on a typical transfer pricing case takes about three years. Such audits also routinely require the employment of experts. Based upon our own less than acceptable audit experience and the insights we acquired through this training on the use of IRC Section 482 and the arm's length pricing standards and rules which it demands, we have concluded that this approach is ridiculously impractical. Please remember that our audit involved only one transaction.

We understand that most arm's length pricing cases require the analysis of transactions which may occur many times each day in a variety of different currencies whose value relative to one another is constantly changing.

By comparison, use of the combined reporting method is dramatically easier whenever an audit of related corporations is necessary. Its value lies in its simplicity and the fact that its

results cannot be manipulated by use of less than arm's length pricing between or among included corporations.

Businesses operating in Idaho may elect to use one of two combined reporting methods. The first, which we call water's edge reporting, limits the companies which may be included to those incorporated or operating within the United States. All others are required to use the combined reporting method for their worldwide operations. If they report using the worldwide method or their business is conducted exclusively within the United States, there is no opportunity for dispute about the arm's length nature of transactions between members of the affiliated group because no income or loss may be recognized from these transactions. It is only when a member of the group enters into a transaction with a third party...one not included in the combined report...that a taxable transaction may occur.

When the entirety of the business conducted by the affiliated group is divided by some jurisdictional barrier, opportunities for tax avoidance through less than arm's length pricing become a possibility. Such is the case now for affiliated corporate groups operating in Idaho when the water's edge method of reporting is elected. For these taxpayers an artificial line separates that portion of their business which is conducted within the United States from the balance of their business elsewhere throughout the world. This artificial barrier provides the opportunity for income manipulation through variations in international pricing among two or more segments of the same business.

Since Idaho relies exclusively upon the international examinations performed by the Internal Revenue Service, we are concerned that these efforts are as

effective as possible. From our experience with the Section 482 issue described earlier, and

from all we have learned about the difficulties IRS faces when they try to apply these rules, we believe Idaho is not receiving the revenue it should from these corporations.

We strongly urge you to adopt rules at the federal level which substitute the apportionment concepts, which many of the states have successfully used for years, for the arm's length pricing standards which have proven to be administratively unworkable and ineffective. In the alternative, Section 482 rules should be modified to require use of formulary apportionment when the existing arm's length pricing provisions do not work. Use of the apportionment concept at the federal level will make tax compliance easier and more verifiable, but more importantly, it will improve the equity of the current system.

Thank you for the opportunity to speak with you today. May I answer any questions for you?

Senate Governmental Affairs Committee
March 25, 1993
Written Testimony of Benjamin F. Miller
California Franchise Tax Board

California has used the unitary method of accounting for over fifty years. As practiced by California, the unitary method of accounting has two basic elements: formulary apportionment and combined reporting.

Formulary apportionment, a process used by every state which asserts a tax on or measured by income, uses a mathematical formula to assign income on a geographic basis. The formula which is used by most states compares the property, payroll and sales of a business which are located within the state to those same values of the business everywhere. Three percentages are determined and then averaged to determine the percentage of the business's activity which takes place within the state. This percentage is then applied to the total income of the business to determine how much should be assigned to the state. There are several virtues to this system: First, there is mathematical certainty that there can be no multiple taxation if all jurisdictions use it. Second, it provides a simple mechanical solution to what is probably an insoluble question: the specific location and activity which gives rise to income. Third, it is less vulnerable to manipulation.

Combined reporting requires that all commonly owned or controlled activities which function as a single economic business will be considered as such regardless of the corporate form in which they are carried on by the enterprise. Under combined reporting, there is virtually no significance attached to the legal form, divisions or separate corporations in which the business is conducted. Use of combined reporting, or a similar mechanism such as the federal consolidated return, prevents a business from avoiding the consequences of formulary apportionment through the use of separate corporate entities. Combined reporting, consolidated returns, or similar mechanisms which require a cumulation of the results of commonly owned entities is probably the single most effective tool a tax administrator can have to combat manipulation of income for tax purposes through the use of formal, legal entities because the results of a business are determined solely by reference to third-party transactions, real arm's-length accounting.

History of Unitary Method in California

When California first implemented the unitary method, it was used only in those circumstances where the tax administrator felt it was necessary as a device to combat taxpayer manipulation of its separate accounting results. As California began implementing the combined report approach, it extended it to both domestic and foreign country affiliates. These extensions occurred not only through action of the Franchise Tax Board but

also at the request of taxpayers where there were interjurisdictional transactions.

Taxpayers, however, also saw that the unitary method could be used as a means for them to prevent the multiple taxation which can arise from the separate accounting method even when interjurisdictional transactions are not involved. In the companion cases of Superior Oil Co. v. Franchise Tax Board, 60 Cal.2d 406 (1963), and Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal.2d 417 (1963), the taxpayers sought refunds of their California taxes paid on the basis of separate accounting by asking the courts to require the Franchise Tax Board to allow them to use the unitary method. The California Supreme Court, in ruling for the taxpayers, held that when a unitary business relationship exists, the unitary method of accounting must be used. In both of these cases, the taxpayers argued for the use of the unitary method to allow them to offset losses arising from activities in other jurisdictions against gains in California so they would not be required to pay a tax to California on an amount of income in excess of their total income.

Following the decisions in the Honolulu and Superior cases, the Executive Officer of the Franchise Tax Board made the determination, based upon the mandate of the California Supreme Court, that the department would require the use of the unitary accounting method whenever related entities exhibited a unitary business relationship.

From the inception of the California Bank and Corporation Tax Law in 1929, formulary apportionment has been applied to interstate and foreign commerce. The combined report mechanism was not advanced by the Franchise Tax Board until the early '30's and it is difficult to determine when it was first used with respect to corporations conducting activities in foreign countries. However, there are reported administrative decisions which reflect the fact that corporations with activities in foreign countries were included in combined reports as early as 1945. We believe that in several circumstances foreign activities were included in the determination of the California tax at the taxpayer's request.

With respect to foreign-based businesses, we have records of cases involving foreign-based banks where the unitary method was proposed in the mid-1950's. Prior to the Honolulu and Superior decisions, it is likely that the use of combined reporting with respect to foreign-based businesses was the exception rather than the rule. Single-entity formulary apportionment, however, was almost assuredly used for all foreign incorporated taxpayers from the outset of the Bank and Corporation Tax Law as there was United States Supreme Court authority for its use, Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924).

Use of the unitary method for foreign-based businesses was not a significant issue prior to 1970 for two reasons. First, the Franchise Tax Board had not considered the full use of the

unitary method mandatory. Second, because there was United States Supreme Court authority validating, at least in part, its use. And third, and probably most importantly, the wave of foreign investment in the United States, and more particularly in California and the other western states, had not yet hit.

In 1975 the unitary method, and its use in California, achieved celebrity status when the United Kingdom, in renegotiating its Tax Convention with the United States, obtained the agreement of the United States negotiators to include a clause in the treaty which would have prohibited use of the worldwide combined report method. The inclusion of this proposed restriction on a method of accounting used by the states was the first time that state taxes on or measured by income, with the possible exception of nondiscrimination clauses, had been dealt with in a bilateral United States tax treaty. In fact, at that time, and even to this day, the United States Model Income Tax Treaty specifically exempts state income taxes from treaty coverage except for the general nondiscrimination clause.

In 1978 the treaty was presented to the United States Senate for its "advice and consent." The treaty, with the offending clause, was unable to obtain the necessary two-thirds vote for ratification. Subsequently, the treaty, without the clause, was ratified by the Senate. Two years later, after negotiating additional concessions and with much grumbling, the United Kingdom Parliament also approved the treaty. Shortly thereafter, the United States State Department began to receive diplomatic notes of complaint regarding the states' use of worldwide combined reporting from a variety of foreign countries, with the United Kingdom being the most strident in its complaints.

Concurrent with the treaty debate and resolution, taxpayers were pursuing legal remedies against the states, and California in particular. In 1983 in Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983), the United States Supreme Court sustained California's application of the worldwide combined report accounting method with respect to a United States-based multinational, characterizing the accounting method as "fair and proper." In the Container decision, the Supreme Court specifically reserved the question of whether the worldwide combined report method could constitutionally be applied to foreign-based unitary businesses. 463 U.S. at 189 fn. 26 and 195 fn. 32.

California is still litigating the question of whether the worldwide combined report method can be constitutionally applied to foreign-based businesses. California has prevailed in its state courts, 2 Cal.4th 708 and 10 Cal.App.4th 1742 (1992), and there is presently pending before the United States Supreme Court a Petition for Writ of Certiorari in the case of Barclays Bank International Ltd. v. Franchise Tax Board, Docket 92-1384. It is expected that the Court will decide whether or not to grant the petition before it recesses this summer. If the petition for

review is granted, argument is likely to occur early in the next term.

After the decision in Container, President Reagan called for the formation of a Working Group to attempt to seek a solution to the states' use of the worldwide combined report accounting method. The solution sought was to strike a balance between the rights, powers and needs of the states, the complaints of foreign countries and their citizens, and the concerns of domestically based multinationals. The product of the Working Group was agreement as to several principles by which modification of state tax systems would be undertaken and the proposal of several alternative solutions, none of which was fully endorsed by all of the parties. As part of the package, the federal government agreed to undertake a variety of initiatives in the area of transfer pricing, including providing both training for state tax auditors and increased enforcement efforts on the part of the Internal Revenue Service.

As a result of the Working Group deliberations and suggestions, the states have acted to modify their use of the worldwide combined report accounting method. With a single, and even in that case, limited exception, the states have abandoned the requirement that taxpayers include their foreign incorporated activities in a combined report calculation. States such as California have accomplished this result by allowing the taxpayers to elect between the use of worldwide combined report accounting method or a "water's-edge" combined report method.

Mechanics of Unitary Method

Based upon our experience, we have concluded that the unitary method can be used with respect to foreign-based multinationals and it is an effective tool for collecting a fair and proper share of tax revenue from them which eliminates the need to engage in the intricacies of arm's-length accounting. A unitary audit consists of the following steps:

First, a determination has to made as to which entities constitute the unitary business whose income should be considered by the Franchise Tax Board. In the case of many foreign-based businesses, the United States activities are distribution arms for a product manufactured overseas, a classic unitary relationship. In other circumstances, the inquiry is more difficult and time-consuming because the foreign activities may include businesses which are not so clearly related to the activities carried on in the United States. Nonetheless, published Annual Reports and similar documents often provide the necessary evidentiary base for a conclusion as to the extent of the unitary business and allow for a separation of the unrelated activities.

Second, a determination must be made as to the income of the unitary business. California has adopted a regulation, Reg. § 25137-6, California Code of Regulations

which directs how this is to be done and provides for the use of alternative data and estimates where necessary. The starting point of this effort is typically the published financial data of the parent company. This data must be adjusted to conform to United States accounting principles and to tax accounting principles. Published financial statements or other material prepared in order to access United States financial and credit markets often exist and indicate the differences between United States and the foreign country GAAP. Adjustments to foreign accounting data are only made when the effect is material, Reg. § 25137-6(b)(3)(C). (The California provisions with respect to this were copied out of Internal Revenue Code regulations, Reg. 1.964-1(a)(5).) In this regard, it is important to keep in mind that many accounting treatments, such as depreciation, relate to timing questions and permissible choices of methods, not to ultimate reporting.

The Franchise Tax Board is always prepared to make adjustments requested by the taxpayer, if appropriate. In making such adjustments, it is not necessary to prepare new books and records, but merely to adjust existing data pursuant to some reasonable method. The calculations are normally performed in the currency of the parent company.

Third, a determination is made as to the apportionment factors. The apportionment factors typically consist of tangible personal and real property valued at original cost, payroll and sales. These are values which we believe every business knows. These calculations are performed in the currency of the parent company (Reg. § 25137-6(c)(1)(E) and (c)(2)(C)), the currency in which the books and records are routinely kept for consolidated financial reporting.

In summary, what the Franchise Tax Board needs in order to apply the combined report method to a foreign multinational boils down to seven numbers:

The overall net income of the entire business

The overall value of the business's property, payroll and sales.

The California value of the business's property, payroll and sales.

Logic and knowledge of business practices strongly suggest, and our experience verifies, that all of these numbers are maintained in the normal operation of every business. In most circumstances, this information can be gleaned from published financial records or other records maintained by the business which are available to the department. If publicly maintained financial data is not available, the cooperation of the taxpayer and its affiliates is required to obtain the information. But the

important point to keep in mind is that the information being sought is invariably maintained in the normal course of business.

Costs of Compliance

One of the principal arguments which foreign multinationals raise about the unitary method is the cost of compliance. It is our experience that these arguments are of the "smoke and mirror" variety. In support of our conclusion, we offer the following three examples taken from cases which are actually being litigated. The first two, Barclays Bank International v. Franchise Tax Board and Alcan Aluminum Corporation v. Franchise Tax Board, are obviously cases in which the Franchise Tax Board is involved. The third case, Reuters v. Department of Revenue, involves the State of New York. For purposes of this testimony, I will provide a brief summary of portions of the evidence presented regarding the cost of compliance in each case. If more detail is required, we will be happy to submit portions or all of the record in each of the cases as an addendum to this testimony.

Barclays

Barclays, in support of its cost of compliance argument, in addition to the conclusionary statements of various federal officials, offered the testimony of its in-house tax manager and a partner in a major national accounting firm. Based upon the opinion of these two individuals, the trial court found that compliance for Barclays would entail "the cost to set-up and maintain a system [would be] huge, over **$5,000,000** to establish and over **$2,000,000** annually to maintain." (Emphasis added.) The trial court's decision, and the testimony of these two individuals, ignores among other things:

the fact that the Board's regulation, Reg. §25137-6, calls for adjustments to regularly maintained financial data only if material, and

the evidence that there was only one material difference, the revaluation of assets, for tax purposes between the United Kingdom GAAP statements prepared by Barclays and United States GAAP as noted in a Public Offering Prospectus filed by Barclays with the United States Securities and Exchange Commission, and that the annual reports disclosed the basis of adjusting for this difference and the source of the necessary data.

In addition, the trial court decision gave credence to the incredible testimony of one of Barclays' witnesses who testified that as part of his estimates of cost, it would take "hours, a day, or something like that," Trial Transcript p. 992, to convert a **single number** expressed in Pounds Sterling into dollars when all that is required is to

make a mathematical calculation involving either multiplication or division.

The Board, in response to this testimony, offered in evidence copies of the bills which the taxpayers had received from a major national accounting firm for the preparation of partial worldwide combined reporting returns which the taxpayer had filed with the department. The bills were "on the order of **$900** to **$1250** per year" (10 Cal.App.4th 1742 at 1760, fn. 7, emphasis added) for earlier years. These returns were prepared from the financial records of the Barclays Group which were the ultimate source of the information used by the Franchise Tax Board for its assessments.

Alcan Aluminum Corporation

Alcan offered a stipulation as to its cost to prepare a worldwide combined report a figure of $10.2 million. (Joint Stipulation ¶ 139, Exhibit XVI.) As part of its offer with respect to the cost of compliance, Alcan listed 15 separate items which it claimed would require adjustment to go from its financial accounting records to California tax accounting. (Joint Stipulation ¶¶ 44 and 45.)

The stipulation then provides detail with respect to each of these 15 items. (Joint Stipulation ¶¶ 47 through 135.) The stipulation indicates there

> was no adjustment required with respect to five of the items,
>
> that different treatment could be elected, but was not required, with respect to five of the items and that an election was allowed with respect to three of them,
>
> that there was a difference in treatment with respect to the remaining five items, three of which were adjusted, two of which were not, to the taxpayer's benefit.
>
> With respect to all of the items except foreign exchange, where there was not a difference in treatment, the place where the necessary accounting information would be located in regularly maintained books and records was identified.

In addition, the stipulation sets forth the costs incurred by Alcan in filing worldwide returns with California, not to exceed $25,000 for 1965 and 1966 (Joint Stipulation ¶ 137) and not to exceed $75,000 for 1972 through 1974 (Joint Stipulation ¶ 138) and making calculations for the adjustments which were allowed and proposed. (See Joint Stipulation ¶¶ 151 through 153.) The

total costs listed for 13 years of filings which were accepted by the Franchise Tax Board do not exceed $500,000.

Reuters v. Department of Taxation

Reuters is a United Kingdom corporation which does business through branches or offices in approximately 80 countries including New York state. New York law requires that the income assigned to New York be determined by considering all of the income of the corporation and assigning part of the overall income on the basis of the three-factor apportionment formula.

Reuters offered the testimony of the head of its tax department that it would have start-up costs of $86,000 and annual costs of $980,000 to comply with New York's requirement that it calculate its New York tax on the basis of its entire net income.

This testimony was found to be "greatly exaggerated" on the basis of the fact that 1) Coopers and Lybrand had in fact filed the return required by New York for one of the years at issue and 2) thirteen days after meeting with a representative of the State Tax Commission, Reuters was able to supply the necessary information to the Tax Commission for the other two years thereby reducing the proposed assessments from a total of $1,278,767 to $95,195.

The Revenue Which Might be Involved

A question which we are frequently asked, and which we believe will be of interest to this committee, is how much revenue might be generated at the federal level by the use of a method similar to worldwide combined reporting as compared to arm's-length accounting. Our experience suggests that the money involved is substantial, and we offer the following facts in support of our conclusion.

Alcan Aluminum Corporation

In the court case which is currently pending in California, the stipulation sets forth the United States federal taxable income of Alcancorp for the years 1965 through 1974. (Joint Stipulation ¶ 24.) For the first six years, the amounts are negative, and the ten-year total is a negative income of $7,782,000. In contrast, for every year the income assigned to California is a positive figure and for the ten years it totals $19,396,177. (Joint Stipulation ¶ 21, Exhibit XVIII.) This is a difference of over $28,000,000 is spite of the fact that California represents only a portion of Alcan's total United States operations.

In addition to the state proceedings, the parent company, Alcan Aluminium Ltd., unsuccessfully sought to litigate the constitutionality of the worldwide combined

reporting method in the federal courts, Alcan Aluminium Ltd. v. Franchise Tax Board, 493 U.S. 331 (1990). The stipulation of facts in that case covered more years, 1965 through 1978, and reflected positive United States federal income of $55,580,000 because of income of over $61,000,000 in 1978.

ICI Americas

A second taxpayer, Imperial Chemical Company Limited, was joined in the federal action brought by Alcan Aluminium. The stipulation of facts in that case reflects that ICI Americas had total federal taxable income of $105,253,386 over a ten-year period. (Joint Appendix, pp. 44-45, ¶12.) Use of the worldwide combined report method, and extrapolating back from the amount of income assigned to California, would yield a federal taxable income base of $435,399,720 for the same period. (Joint Appendix, pp. 47-50, ¶ 19 and pp. 44-45, ¶ 12.)

The Pickle Committee Hearings

In June of 1990, the Pickle Subcommittee of the House Ways and Means Committee conducted hearings on the question of whether foreign multinationals were paying their fair share of United States taxes. As part of the hearing, a staff report was presented which focused on 36 foreign-owned companies in two industries, electronics and automotive/motorcycle, for a ten-year period. During the course of the hearing, the names of companies which were believed to be included in the study came out. In addition, the names of several banks were listed as being involved in a similar study. The study involved a total of 222 returns, with payments of $5.0 billion to the United States, or an average payment of slightly more than $22.5 million per return. (It was not clear, however, from the material which we reviewed whether the effects of net operating losses were taken into account in computing the total amount paid and, therefore, we could not determine whether the $5.0 billion represents the actual final payments.) Nonetheless, if one uses the average payment per return, and assumes a United States corporate income tax rate of 50%, the average United States income would be $45 million.

The material submitted at the Pickle Committee hearings, California's recent conversion to elective water's-edge combination, and our interest in trying to determine what the actual cost of that conversion might be aroused our interest in this material. As a consequence, we initiated our own study of what a similar group of corporations might have paid to California in the worldwide combined report environment. To the extent possible, we duplicated the list of companies named in the Pickle hearings and added several others in an effort to have comparable numbers. The results of that first study

suggested that the federal government could have received 30% more tax under a worldwide combined report system than it had received under the arm's-length approach.

We have recently updated this study. For California purposes, we were able to identify a total of 117 returns covering a ten-year period. The average income assigned to California on these returns was roughly $25 million after audit. This is only the income assigned to California, not the income assigned to the United States. To determine how much income would be assigned to the United States under a worldwide combined reporting method, it is necessary to make a determination of what portion of total United States activity California represents. If one assumes that California represents 50% of the United States activities for these corporations, the total federal income should have been $50 million, or 11% higher. If one assumes that California represents 12.5% of total United States activity, roughly the assumption California uses in attempting to project the effects of adopting changes made in the Internal Revenue Code, the income assigned to the United States would be $200 million per taxpayer, or four times what was reported to the federal government.

Conclusion

In summary, there are a number of lessons which California has learned from this experience. First, foreign-based businesses know how to make their political presence felt in the capitals of their countries and in both Washington, D.C., and Sacramento, California. Second, foreign multinational corporations are dogged and resourceful opponents in both the judicial and legislative arenas. Third, foreign-based multinationals can comply with the unitary method when they wish to do so. Fourth, the "smoke and mirrors" game of cost of compliance can be played effectively in a number of arenas and it is difficult to counteract such claims because of the difficulty of separating fact from fiction. Fifth, a substantial amount of tax can be collected from foreign-based businesses under a unitary method. Sixth, and finally, the training which we have received from the Internal Revenue Service and our first experiences with the arm's-length accounting method strongly suggest that it has little to recommend it in terms of either simplicity or effectiveness in raising tax revenues.

STATEMENT OF LOUIS M. KAUDER
BEFORE THE
GOVERNMENTAL AFFAIRS COMMITTEE
OF THE
UNITED STATES SENATE

March 25, 1993

I am pleased to have the opportunity to appear at this hearing regarding administration by the Internal Revenue Service of international transfer pricing rules.

A. Summary

For many years I have practiced tax law in Washington, D.C. Recently, I published a paper in which I recommended that Treasury adopt formulary apportionment as a principal means of determining the U.S. taxable income of multinational firms (multinationals).1/ Today I reiterate and explain that recommendation.

Formulary apportionment in most cases should replace the existing "comparable price" methodology. That current method requires the Internal Revenue Service to find transactions among unrelated parties that look like the transactions among members of the multinational group being examined. It then must deduce the "correct" U.S. taxable income of the multinational from the prices used in the outside transactions. The process invites continuous,

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1/ Tax Notes, January 25, 1993, pp. 485-493.

expensive, and inconclusive argument over the degree of comparability between the transactions and prices being compared.

Formulary apportionment instead would look at all, or some relevant part, of the actual worldwide income of the multinational group and on some quantitative basis apportion part of that income to the group's U.S. operations. Outside transactions involving other parties generally would be irrelevant.

Some Treasury officials and taxpayer representatives recently have said that U.S. formulary apportionment of the worldwide net income of multinationals will inevitably result in double taxation because apportionment contradicts accepted norms of international taxation, and indeed would violate specific tax treaty obligations of the U.S.

I disagree. In my view I.R.S. use of formulary apportionment in appropriate cases under section 482 of the Internal Revenue Code is not prohibited by any U.S. tax treaty and is no more likely to generate double taxation than any of the numercus methods now employed by the I.R.S., and by foreign tax authorities, to test the transfer pricing mechanisms of multinationals.

Tax treaty rules on the subject are stated in general and amorphous terms. In substance the treaties only recite that each country may adjust the tax liability of one company in a multinational group whenever the financial arrangements among group members is different from what those arrangements would have been if the companies had been independent. However, the treaties assure multinationals that local affiliates of foreign-based

multinationals will not be taxed more onerously than businesses wholly based in the taxing country.

The treaties do not limit each country's internal choices of methods with which to test related party transactions. Rather, the treaties simply recognize that each country's tax authorities are empowered by internal law to make adjustments among related parties and that double taxation could result in individual cases in the absence of bilateral consistency.

The newer treaties put in place procedures under which the two tax authorities are committed to discussing whether an adjustment by one country that increases the tax liability of one of two related parties warrants a correlative adjustment by the second country in favor of the other related party. These procedural agreements do not impinge on the unilateral authority of each country to decide for itself what means it will use to identify the taxable income of a domestic affiliate of a multinational.

The United States has never agreed in any treaty to adhere to any particular methodology in determining what adjustments among related parties are appropriate as a matter of domestic law. Conversely, no country has ever agreed in a tax treaty with the United States simply to accept adjustments that are grounded on the particular methods stated in the I.R.S. transfer pricing regulations, either as they now exist or as the I.R.S. might change them in the future.

In the context of existing treaties and international tax policy generally, formulary apportionment emerges as a timely evolutionary development. Its formal adoption by the United States or any other country would not constitute a flaunting of any established norms of international taxation.

B. Background

My original understanding of transfer pricing issues developed while I was an attorney in the Office of International Tax Counsel at the Treasury Department in the period 1969 through 1972. I designed and executed the first Treasury-sponsored study of I.R.S. administration of the original transfer pricing regulations, and I drafted the report of that study ultimately published by Treasury in January 1973.

As a member of Treasury's international tax staff I participated in numerous tax treaty negotiations, during which I had particular responsibilities regarding the related party article of the treaties and the implications of the original I.R.S. transfer pricing regulations in relation to those treaty articles.

Immediately following my Government service I prepared a paper at the request of the United Nations on the problems of international transfer pricing administration and compliance.[2/]

Members of this Committee have expressed concern that the present system for identifying the correct U.S. taxable income

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2/ International Allocations of Income: Problems of Administration and Compliance, 9 Jl. of International Law and Economics 1 (1974).

of affiliates of multinationals isn't working and that enormous amounts of income earned in the United States by multinationals is going untaxed. Representatives of the Government, academia, and the private sector recently have expressed varying views on the extent of the problem and how to solve it, but virtually all agree that a substantial problem exists.

It is not my purpose today to establish that a problem exists or the extent of it. I assume that it exists and address what to do about it.

C. The Comparable Price Method Generally Does Not Work and Cannot Be Made to Work.

Current regulations under section 482 invoke the "arm's length" standard and establish three methods for testing whether a sale of property between related parties meets that standard. Each of the three methods requires identification of the price at which unrelated parties actually completed a comparable transaction (involving either the direct sale of property, the allowance of a resale markup to a selling intermediary, or the allowance of a cost-plus markup to a selling manufacturer). Similar rules of comparability apply in cases of payments for intangibles, services, and property rentals.

We sometimes lose sight of the fact that under these U.S. rules an outside transaction must be found as a condition to applying any one of the three available methods, and not just the first, and preferred, "comparable uncontrolled price" method.

However, the I.R.S. may use unspecified "other" methods for testing the adequacy of a multinational's prices if none of the three prescribed methods can reasonably be applied. Studies over the past 25 years show that resort to a "fourth" method to resolve a transfer pricing dispute under section 482 frequently occurs because of the absence of available comparables that are needed to implement any one of the prescribed methods.

The absence of persuasive comparables is the principal reason the present system cannot be made to work. Almost universally in the large cases, outside comparables cannot be found in any reliable or useful form. The search for them simply inhibits identification of a reasonable amount of the total net income of a multinational that is properly subject to income tax in the U.S.

All tax systems should recognize that multinationals exist and prosper because their related elements are in fact integrated and unique. Tax authorities and international tax specialists concede the point, but nonetheless adhere to a system that ignores it.

The multinational transcends governments, which are inherently fragmented. Within the world of multinationals each one represent a separate culture. Differences among them provide fertile ground for distinguishing away comparables that may be offered by the I.R.S. to support proposed adjustments to a multinational's pricing mechanism. On the other hand the multinational's sophisticated understanding of its own lines of business ultimately enables it to find and present analogies to its reported

pricing methods that the I.R.S. is unable effectively to assess or critique.

For example, suppose a foreign auto company sells transmissions to its U.S. subsidiary which are assembled into autos in the U.S. for sale here. The I.R.S. may find similar transmissions sold to unrelated parties by a U.S. company either in the U.S. or elsewhere, and argue that the outside transaction establishes the correct "arm's length" charge. The foreign auto company will then show that its transmissions are different, that its whole approach to designing and assembling an auto is different from that of the outside seller, and that with those factors taken into account the I.R.S. analogy must fail. The same kind of distinguishing arguments commonly are available even where the outside transaction in issue involves a member of the multinational being examined.

Other kinds of property and services are even more difficult to fit into any of the comparable price methodologies, as for example software technology, drugs, chemicals, movies and TV programs, power generation equipment, airplanes and airlines, communications systems, etc.

These kinds of arguments have been, and will continue to be, very difficult for the Government to win, irrespective of how many qualified experts it is able to employ and irrespective of whether the multinational reports a reasonable amount of U.S. net income or none at all. Given the imprecision of the legal

standard, it is difficult to conclude that the Government is entitled to prevail in these kinds of disputes.

Essentially, the comparable price problem is one of valuation, but unfortunately the method requires the valuation of goods-in-process, intangibles, and even services that are not routinely bought and sold in public markets. Further, the method requires such valuations with respect to hundreds of billions of dollars of related party transactions involving U.S. corporations every year. These valuations must be accomplished in the context of a corporate <u>income</u> tax, where a swing of 5% or 10% of receipts can eliminate the potential tax base entirely. In the context of a customs duty or an estate tax such swings are at the margins of the tax base, and compromises are usually attainable with no significant jeopardy to the tax system. However, an <u>income</u> tax system that relies so heavily on a valuation methodology is vulnerable to desiccation, especially where the taxpayers involved are knowledgeable and sophisticated. The empirical data suggest that this is happening.

The I.R.S. now seeks to improve transfer pricing enforcement with temporary regulations, just published, which offer additional elaboration of what constitutes a comparable price or a comparable transaction. The new regulations also provide details on what taxpayers must do to avoid substantial transfer pricing penalties enacted into law several years ago. In recent years Treasury and I.R.S. officials have said they plan to commit

increased I.R.S. resources to transfer pricing issues, and the Clinton administration has already made a similar commitment.

No doubt the penalties raise the stakes for multinationals, and more I.R.S. resources will increase taxpayer costs to defend their transfer pricing mechanisms. But there is no good reason to believe that the newly elaborated comparable price rules or the penalties will have any impact on the problem that concerns this Committee.

The situation is something like organizing an Easter egg hunt without first hiding any eggs. No matter how many children are invited to join in the search, and no matter how detailed the instructions are for finding the eggs, none will be found because none are out there.

D. <u>Formulary Apportionment as an Alternative.</u>

Formulary apportionment first identifies an amount of worldwide net income of the multinational that includes the U.S. operation and then apportions that net income among the U.S. and non-U.S. activities of the multinational on some quantitative basis. One version of the method is commonly used by the States to determine the intrastate net income of corporations that operate nationally. Another version has partially developed in bits and pieces over the years to identify the portion of a foreign corporation's income that is properly attributable to the corporation's U.S.-based branch or office.

Apportionment has important advantages over the comparable price methodology. It operates only by reference to data drawn entirely from the multinational. It accepts the actuality of the integrated multinational and does not force an analysis based on the fiction that the U.S. affiliate of the multinational operates separately from the group of which it is a part.

Years ago it was generally held that formulary apportionment could not be made to work internationally because no single tax authority could uncover and establish a multinational's consolidated taxable income, a necessary predicate to apportionment. Today, international standards of financial reporting, and in some cases specific legal requirements, make this aspect of information gathering much more feasible.

The I.R.S. itself has adopted regulations under sections 6038A and 6038C of the Code designed to require multinationals to produce on request data that reveal the group's worldwide net income. The maintenance of financial data by "industry segment" within a multinational is also common practice today. U.S. and foreign tax authorities therefore should be able to segregate the part of a multinational's worldwide income that encompasses activities in the taxing country from the group's broader, all-inclusive income, where the facts warrant such segregation. In those cases an apportionment formula should apply only to the correct industry segment.

I can suggest no particular apportionment formula that I would recommend to displace the flawed comparable price methodolo-

gy. I would look closely at what would work and what would not work if the States' three-factor formula for apportioning income to a particular state were applied internationally.[3] California has accumulated substantial experience doing this for purposes of its income tax.

I would also cautiously examine the formulae applied to determine the effectively connected U.S. income of foreign corporations under sections 861-865 of the Code for analogies. It also may be appropriate to establish separate formulae for specific industries or groups of industries (i.e, large hardware manufacturing, food and beverages, entertainment, chemicals, drugs, commodities, etc.).

Formulary apportionment need not govern every case. Where a multinational can convincingly prove that its U.S. affiliate functions independently of the rest of the group, and its transfer prices are determined by independent negotiation and market forces, apportionment would be superfluous. Apportionment may also be inappropriate where fungible, widely traded commodities are involved.

If related party transactions account for a relatively minor percentage of the receipts or expenses of the U.S. affiliate of an multinational (e.g., less than 10%) and their dollar volume is relatively low, apportionment (but not the general requirements

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3/ The three-factor formula in terms would have been added to section 482 by an amendment proposed by the Treasury Department and adopted by the House in its version of the Revenue Act of 1962, but the amendment was dropped from the final bill.

of section 482) could safely be foregone at the option of the taxpayer.

I believe that Treasury and the I.R.S. are the appropriate institutions to establish and develop particular methods of formulary apportionment under section 482. Administrative authority to do so already is conferred by section 482; no amendment to the law is required for this purpose.

E. Tax Treaty Provisions Do Not Preclude Formulary Apportionment.

Almost all of our tax treaties have a "related party" article. Typically, this article recites that each country may make tax adjustments to one of two related parties when commercial and financial arrangements put in place by those related parties are different from the arrangements that would have been made between independent enterprises. In such cases the article says that the income or deductions of one of the related parties that would have been taken into account but for those special and different commercial or financial arrangements may be taken into account in determining that party's tax liability.

In substance the treaties say no more than this. Secondary commentary on these treaty provisions, such as U.S. Treasury and Senate committee technical explanations, as well periodic commentary of the Organization for Economic Co-operation and Development (OECD), describe these provisions as establishing an "arm's length" standard. However, the treaty articles provide no guidance, and certainly no agreement among the two countries, as

to how the differences between related party and unrelated party arrangements in any case are to be identified, what kinds of evidence will establish such differences, and what kinds of adjustments are appropriate or satisfactory to take account of any such differences once they are found. That is, the critical tax enforcement questions are left to be determined by local law in each instance.

On procedural matters many of the newer U.S. tax treaties say more. They provide that where one country makes a related party adjustment of the kind described in the treaty, the other country shall make a corresponding, or correlative, adjustment in the tax of the other related party if certain conditions are present. The second country's obligation to make the correlative adjustment is generally conditioned on that country agreeing with the first country's determination, and must be made only where the correlative adjustment is necessary to avoid double taxation or where it is "appropriate." (Discussions between the taxing authorities on these issues are referred to as "competent authority" proceedings.)

The related party articles do not have a command or prohibitory effect, wholly apart from their indeterminate substance. Under those articles neither country is committed to any particular set of rules, "arm's length" or otherwise, to determine the taxable income of companies that are organized in and operate in their countries. Each country remains free, as if there were no

treaty at all, to adopt whatever rules it chooses for resolving transfer pricing issues involving related parties.

This residual freedom with respect to transfer pricing methods should be distinguished from the specific treaty limitation on one country's direct taxation of a corporation that is based in the other country. Under the treaties the U.S. agrees not to tax the business profits of a corporation organized in the other country except as to profits attributable to an office or agency (referred to as a "permanent establishment") of the foreign corporation located in the U.S. The related party articles of the treaties do not have a prohibitory effect equivalent to the business profits/permanent establishment provisions. It is wrong to suggest that they do.

Each treaty country hopes, however, to avoid double taxation. That is a principal reason for having tax treaties in the first place. But on the transfer pricing issue, international negotiations have not developed to a point where countries are willing to enter into bilateral agreements as to the specific content of transfer pricing rules which will bind both countries to specific methodologies in individual cases. The hortatory "arm's length" standard is no such rule, even if that standard can be extracted from the oblique and elliptical language of the related party articles.

The situation today is that no foreign country is bound to accept any particular I.R.S. adjustment, including one that is made precisely in accordance with the preferred comparable

uncontrolled price method in the current regulations. Rather, each treaty country agrees simply to endeavor to reach agreement on correlative adjustments whenever disagreement initially arises. Where those endeavors may lead in any individual case just depends on the case.

Many surveys show that in individual cases under section 482 disputes are often resolved administratively by formula division of combined profits. It is reported that one very recent transfer pricing agreement under section 482 between a multinational and the I.R.S. is based on an apportionment formula. Against this background I do not understand, and thus do not share, the apprehension that if formula apportionment of combined net income of an multinational is directly written into the regulations under section 482, the resulting allocations are more likely to be denied correlative adjustment in foreign countries than are adjustments based on comparable prices under the existing I.R.S. regulations.

The matter can be put another way. Does the I.R.S. categorically reject, in competent authority proceedings, any correlative adjustment sought by a U.S. related party based on a foreign country's use of a formula to justify an initial adjustment in that country? If so, the I.R.S. has never said so. Nor has any foreign country, or the OECD, so far as I am aware, ever said that categorical rejection of adjustments based on formulary apportionment is the correct stance under these treaty provisions.

The comparable price methodology seeks to approximate an "arm's length" result. So does formula apportionment, but the latter has the distinct advantage of providing a reasonable quantitative answer directly from the records of the taxpayer's group and does not require either the taxpayer or the I.R.S. to roam the countryside in an effort to find transactions that look like the transactions being tested.

In short, the treaties plainly do not prohibit formulary apportionment. The only treaty question is whether a correlative adjustment claimed by the other related party will be allowed by the foreign country in question if the initial adjustment is based on a formula. The answer to that question is the same as it is today when the I.R.S. makes an adjustment under the current rules. We always hope the foreign country will make the correlative adjustment in appropriate cases, and we expect the foreign country to be reasonable.

F. An Assessment of the Twin Specters of Double Taxation and Foreign Retaliation.

An increase in the U.S. tax of a multinational based on an adjustment under section 482 does not automatically imply double taxation. The original impetus for increased enforcement activity under section 482 in the 1960s was the apprehension that U.S.-based multinationals were shifting taxable income to tax haven countries through manipulative pricing arrangements. Typically those havens were foreign countries somewhat out of the mainstream of interna-

tional industrial or commercial activity (e.g., Switzerland, Luxembourg, Panama, Cayman Islands). In those kinds of cases the increased U.S. tax was expected to fill a vacuum of little or no tax on the other side, and of course double taxation in those circumstances would not be an issue. To the extent those cases persist, little or no double taxation will arise today no matter what methodology is used to make the allocation under section 482.

Even where the U.S. makes a transfer pricing allocation involving a U.S. affiliate of a multinational based in a treaty country, double taxation subject to possible resolution under the treaty does not occur unless the increment of income in question actually was reported and taxed in the other treaty country. This does not inevitably occur. Differences in the tax laws of the two countries can result in transactions being reported differently in those countries by the related parties. Tax holidays or concessions of one sort or another may also eliminate the potential for double taxation, while simultaneously providing an incentive for aggressive pricing by a multinational. Again, double taxation is not an issue and the related party articles of any applicable treaty cannot be invoked.

Recent data reported by the I.R.S. show that the amount of section 482 determinations that become the subject of competent authority treaty negotiations today is small in relation to the total of such adjustments made by the I.R.S. It is difficult to draw definitive conclusions from this circumstance. One implication is that I.R.S. adjustments under section 482 often arise in

circumstances where increased U.S. tax does not imply a lesser tax someplace else, or where treaty protection for one reason or another is not available. It is also possible that correlative adjustments under the treaties to avoid double taxation are commonly obtained today without the intercession of the U.S. competent authority. In the former, and more likely, instance, greater use of formulary apportionment would not lead to an increased incidence of double taxation.

The potential for double taxation or retaliatory action by foreign countries against U.S.-based companies must be assessed in light of the data collected during House hearings in 1990 and 1992. In important comparative categories, the ratio of tax paid to receipts for U.S.-based multinationals was dramatically higher than it was for foreign-based multinationals. For example, in the period 1983-1987 U.S. affiliates of foreign-based finance and insurance firms reported a cumulative net deficit in the U.S. equal to 0.3% of total receipts, while U.S.-controlled financial and insurance companies reported cumulative net income equal to 5.7% of total receipts. In manufacturing foreign-controlled U.S. companies showed net income equal to 1.7% of total receipts compared to 4.3% for U.S.-controlled firms.

By curious coincidence, in 1988 foreign affiliates of U.S.-based multinationals reported foreign receipts in an amount almost identical to the total amount of U.S. receipts reported by U.S. affiliates of foreign-based multinationals. In each case the amount was about $825 billion. However, the U.S. controlled firms

paid foreign tax of about $23.9 billion on that amount of receipts, while the foreign-controlled U.S. affiliates paid U.S. tax of about $5.8 billion on the same amount of receipts. This strongly suggests that for U.S. firms operating abroad the ratio of foreign taxes paid to foreign gross receipts is about the same as the ratio of their U.S. taxes paid to their U.S. gross receipts. That is, both in the U.S. and outside the U.S., U.S. firms apparently pay income taxes at a rate (in relation to gross receipts) three or four times greater than the rate paid to the U.S. by foreign-controlled multinationals on their gross receipts here.

What sort of double taxation or retaliatory bite into U.S. tax revenues will occur if formulary apportionment functioned to increase the U.S. side of that equation? Given the dramatic differences in rates of tax paid by foreign multinationals in the U.S. compared to rate paid by U.S. firms both here and abroad, it seems unlikely that foreign countries would categorically deny correlative adjustments in formula-based cases simply to preserve those differences. So long as formulary apportionment is accomplished by means that refute any "grab" by the U.S. for income that plainly should be taxed elsewhere, the circumstances in which correlative adjustments will be allowed by foreign countries should be the same as they are today, and double taxation will be avoided roughly to the same degree as it is today.

Any foreign country retaliation in response to U.S. formulary apportionment that is aimed at U.S.-based firms would seek to increase the rates of tax already being paid by U.S.-based

firms in those countries, which in turn would aggravate the apparent differences between those rates and the much lower rates paid by foreign firms here. The discomfort of some foreign multinationals (joined by some U.S.-based multinationals) at the prospect of formulary apportionment may well induce foreign tax officials to threaten some form of retaliation. In that event the U.S. should respond by demonstrating -

(i) the practical reasons for using formulary apportionment,

(ii) the reasonableness of the particular apportionment methods put in place,

(ii) the availability of other methods in appropriate cases, and

(iv) that comparable price methods and formulary apportionment methods both merely achieve approximations of what hypothetical independent parties would have earned in similar circumstances.

In short, reasonably designed formulary apportionment would not violate our tax treaties, but retaliation against U.S.-based firms by foreign tax authorities in that event would be discriminatory and therefore would violate the treaties. The Committee has no reason to anticipate either violations of the treaties by foreign countries or renunciation of them, should the U.S. move to formulary apportionment.

G. <u>Conclusion</u>

I think it inevitable that the international tax system will move to formulary apportionment much as the U.S. interstate system already has. I believe that change ultimately will be grounded in multinational agreements and in the specifics of apportionment mechanisms incorporated into international accounting standards.

I believe that the United States can and should take the lead in bringing about these international accords and understandings. Unilateral action to that end under section 482 is the first, but not the last, step. The U.S. should not await the development of relevant international agreements. It would be justified in precipitating them for the reasons outlined in my statement.

Again, I appreciate the attention and courtesies extended to me by the Committee and its staff.

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Statement of Robert S. McIntyre,
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Wayne State University Law School
Before the Senate Committee on Government Affairs
On the breakdown of IRS tax enforcement regarding multinational corporations: revenue losses, excessive litigation, and unfair burdens for U.S. producers
March 25, 1993

Multinational corporations, whether American- or foreign-owned, are supposed to pay U.S. income taxes on the profits they earn in the United States. But our tax laws often fail miserably to achieve this goal. As a result, our corporate tax base has been undermined, multinational businesses gain an advantage over their purely domestic competitors and the U.S. tax system subsidizes the foreign operations of multinational firms, sometimes at the expense of American jobs.

Our present system for measuring the U.S. income of multinational business is fundamentally flawed, both in theory and in practice. We need to overhaul our rules governing international allocation of profits, to protect our tax base and our workers. Specifically, we should abandon the complex and unworkable so-called "arm's length" method of allocating profits among countries (which hopelessly asks the IRS to scrutinize hundreds of millions of intra-company pricing transactions) in favor of a formula approach similar to that used by American states (and by Canadian provinces) to allocate the taxable profits of multistate corporations. The pending North American Free Trade Agreement offers us a chance to begin the long overdue move to such a system.

The Defects of the Current "Arm's Length" System

Currently, the IRS attempts to measure how much profit a multinational corporation makes in the United States using what is variously called the "arm's length" or "transfer pricing" or "separate accounting" system. It was established in the 1960s, when trade accounted for only about 1/20th of our gross domestic product. After a long debate, our Treasury Department settled on the arm's length approach (as opposed to a formula system), and then sold it to our trading partners.[1] Essentially, the present system requires multinational companies

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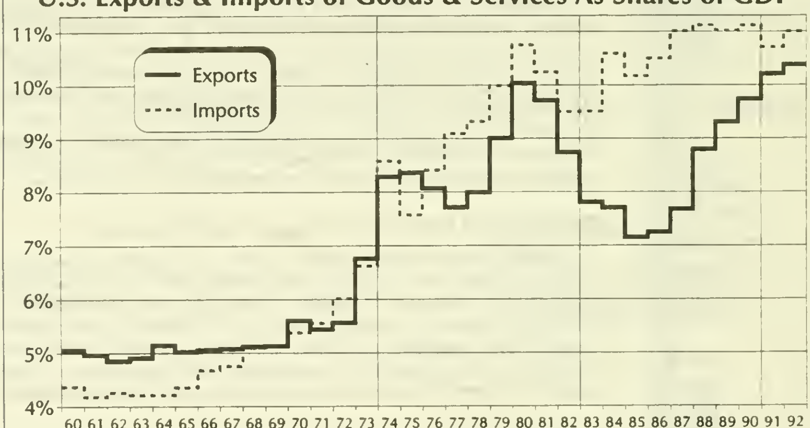
[1]The regulations under section 482 were issued in 1968 in response to an invitation by the Conference Committee Report on the Revenue Act of 1962 to "explore the possibility of
(continued . . .)

to assign "transfer prices" to each real or notional transaction between their domestic and foreign affiliates. In theory, these transfer prices are to be set as if the transactions had occurred between unrelated parties on an "arm's length" basis.

Not surprisingly, in computing their U.S. income, multinational companies try to maximize their U.S. deductions and minimize their U.S. gross receipts. The standard mode of tax avoidance entails setting transfer prices that undercharge or overpay a company's foreign affiliates when goods and services are exchanged or shared. It should be obvious that the opportunities for abuse of this system, under which the IRS is called upon to scrutinize hundreds of millions of transfer prices, are almost endless. In a recent study mandated by Congress, the IRS reported that "a significant section 482 issue may take eight or more years to resolve."[2]

Today, as exports and imports of goods and services have each grown to more than a tenth of our GDP, the fundamental flaws of the arm's length system have been magnified. The U.S. experience with the arm's length standard over the past 25 years shows that it is not well-suited to resolving competing national claims to tax revenues from multinational corporations. Indeed, the complexity and incoherence of the current system encourages multinational firms to file U.S. tax returns that can be best compared to "low-ball opening bids" in a tax-avoidance game in which the companies hold most of the cards.

U.S. Exports & Imports of Goods & Services As Shares of GDP



Figures exclude military. Source: U.S. Dept. of Commerce

[1](. . . continued)
developing and promulgating regulations under [the authority of section 482] *which would provide additional guidelines and formulas* for the allocation of income and deductions in cases involving foreign income." H.R. Rep. No. 2508, 87th Cong. 2d Sess. 18-19 (1962) (our emphasis).

[2]"IRS Report on Application and Administration of Section 482," presented to the House Ways and Means Oversight Subcommittee, Apr. 9, 1992.

Once a multinational company makes its opening tax bid, the IRS must attempt to determine—through adversarial proceedings—what are the flaws in the multitude of transfer prices the company has assigned to its international dealings. The IRS must first try to recalculate the income of each corporate entity in a chain of related foreign and domestic companies under the arm's length standard. It then must apportion the income so determined between U.S. and foreign sources under the source rules of the Code. Through this case by case process, the United States establishes its claims to tax revenue from transnational income. Those claims may and often do conflict with the claims of other countries. Some procedures are available under U.S. tax treaties to reconcile the competing claims, but those procedures are cumbersome and can only be used for a tiny fraction of transfer pricing disputes.

The practical failure of the arm's length standard is by now beyond dispute. For example, most foreign-based multinationals report little or no American taxable income on their U.S. tax returns, despite conducting extensive sales and manufacturing activities in the United States. These companies are able to report such low profit figures by manipulating their transfer prices. Likewise, U.S.-based multinationals frequently employ creative transfer pricing strategies to avoid the bite of the foreign credit limitation rules and to shift income to low-tax countries. The IRS can monitor only a very small fraction of the hundreds of millions of transactions governed by the arm's length standard. Even this limited scrutiny is enough, however, to generate tax deficiencies in the billions of dollars. By the end of this decade, the Tax Court's backlog of section 482 cases may well exceed \$100 billion in disputed taxes.[3]

When Treasury adopted the arm's length approach in the sixties, its architects recognized its complexity, but thought it would be more "accurate" than the simpler formula approach that was also considered. But the truth is that the arm's length system is widely recognized to be theoretically, as well as practically unsound.

"Separate accounting," wrote Professor Jerome Hellerstein in 1983, "operates in a universe of pretense; as in Alice in Wonderland, it turns reality into fancy, and then pretends it's in the real world. For the essence of the separate accounting technique of dividing the income of a unitary business is to ignore the interdependence of the operations . . . , and treat them, instead, as if they were separate, independent and non-integrated."[4] Similarly, former assistant Treasury secretary Charles E. McLure, Jr. has written that "separate accounting *cannot* satisfactorily divide income of a unitary business."[5]

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[3]In April of 1992, then Chief Tax Court Judge Arthur L. Nims III stated that his court had a backlog of section 482 cases with an amount in controversy of \$32 billion and that the amount had doubled in two or three years. These figures are the tip of an iceberg; according to the IRS, about 90 percent of contested section 482 adjustments are settled at the Appeals level without going to court.

[4]Hellerstein, "The Basic Operations Interdependence Requirement of a Unitary Business: A Reply to Charles E. McLure, Jr.," *Tax Notes*, Feb. 28, 1983, at 726.

[5]McLure, "The Basic Operational Interdependence Test of a Unitary Business: A Rejoinder," *Tax Notes*, Oct. 10, 1983, at 99. The theoretical weaknesses in the arm's length approach are explained in Michael J. McIntyre, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES (1989, 1992), chapter 5/D. For additional references to the literature, see the bibliography at the end of that treatise.

Corporate executives have been equally critical of the arm's length system. A 1981 GAO report, for example, cites a 1980 business survey, which found that:

> "Although [multinationals are] composed of numerous legally separate entities, [a majority of the executives of such firms offering an opinion] reveal that their companies make most intercompany pricing decisions as though the organization is one economic unit. This basic difference in philosophy between the IRS and multinational corporations is central to [transfer-pricing disputes]."[6]

The GAO report goes on to relate that corporate officials have called outcomes under the arm's length system "arbitrary" and have complained that "the analytical approach to determining arm's length prices often leads to unreasonable results."[7] A chorus of other experts echoes these conclusions.[8]

To be sure, the temporary and proposed regulations issued under Code section 482 at the close of the Bush administration will make it easier for IRS auditors to identify major transfer-pricing abuses. Those regulations will also close some of the loopholes opened in the old regulations by the courts. They will not do very much, however, to solve the fundamental problems with the arm's length standard. Transfer pricing disputes will not diminish in frequency or in importance. They will be settled, in the appeals process or in the courts, on obscure or arbitrary grounds that will provide little or no guidance for avoiding or settling future disputes. Some companies will continue to avoid paying any significant taxes to any government by taking inconsistent tax positions with the U.S. and foreign tax authorities. Other companies may be subject to double taxation because of inconsistent positions taken by U.S. and foreign tax authorities.

The Better Alternative: Formulary Apportionment

If the arm's length, separate accounting system is a failure, what then is the alternative? The best way for governments to resolve their claims to tax revenues from the in-

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[6]Burns, "How IRS applies the intercompany pricing rules of Section 482: A corporate survey," 52 J. TAX. 308, 314 (May 1980), paraphrased in Comptroller General, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Companies, Report to the Chairman, House Committee on Ways and Means* (1981), at 45.

[7]GAO report cited in note 6, at 44. In its most recent report on transfer-pricing issues, the GAO praised the IRS for its recent efforts to improve administration of the arm's length standard but predicted that "problems with arm's length pricing can be expected to continue." General Accounting Office, *International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices* (1992), at 56. That report discussed formulary apportionment as a promising option to the arm's length method; it concluded, however, that international agreement on formulas could not be achieved in the near term.

[8]*See, e.g.* Stanley Langbein, "The Unitary Method and the Myth of Arm's Length," *Tax Notes*, Feb. 17, 1986, pp. 625-681; Richard Bird & Donald Brean, "The Interjurisdictional Allocation of Income and the Unitary Taxation Debate," 34 CANADIAN TAX J. 1377 (1986). Dale W. Wickham & Charles J. Kerester, "New Directions Needed for Solution of the Transfer-Pricing Tax Puzzle," 5 *Tax Notes International* 399-425 (Aug. 24, 1992). The Multistate Tax Commission has recently circulated a draft report that recommends that the United States move toward an international formulary apportionment system. See Multistate Tax Commission, "Asking Global Corporations to Pay their Fair Share of U.S. Taxes—The Formula Apportionment Income Reporting—FAIR—Option" (Draft dated Dec. 16, 1992).

come of multinational enterprises is through a mechanism that allocates the worldwide income of unified business enterprises by formula among the countries in which those enterprises operate. In a well-designed formulary apportionment system, companies would not go into battle with the tax collectors of each country. They would pay only to the government entitled to the tax revenue under an internationally accepted formula.

In essence, a formula or "unitary" approach would attribute a multinational corporation's current worldwide income among taxing jurisdictions based on some objective measures of its economic links with those jurisdictions. For example, net income might be apportioned among taxing jurisdictions according to a weighted percentage of sales, payroll, and property within those jurisdictions. This is the system used by most American states and by the Canadian provinces.

Such a formula system would eliminate much of the complexity of the present arm's length approach. It would also implicitly end what remains of tax "deferral" on international profits, since total current worldwide income would be included in the base for applying the formula. This would not only provide additional simplification, but would also address the "runaway plant" issue that Rep. David Obey and then-Rep. Byron Dorgan tried to deal with when they introduced H.R. 2889 in 1991.

Of course, the formula method will not yield perfect results in all instances. Nor will it solve all administrative and implementation problems.[9] But the formula method will produce consistent, fair outcomes—a far cry from the current arm's length system. As one commentator noted:

> "Perhaps the underlying reason for its superiority is that the formula approach makes no claims to achieve a perfect result. It recognizes, rather, that a perfect allocation is impossible. The unitary system seeks a reasonable division of income by formula. The arm's-length standard strives for reasonable accuracy, but it fails to achieve it and its theoretical basis is unsound."[10]

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[9]Some of the problems that may arise in the design of a formulary apportionment system are outlined and some solutions to those problems are suggested in Michael J. McIntyre, "Design of a National Formulary Apportionment Tax System," 1991 NTA-TIA Proceeding, 84th Annual Conference 118-124. That article also explains the many potential advantages of switching to a formulary apportionment system.

[10]Harley, "International Division of the Income Tax Base of Multinational Enterprise: An Overview," *Tax Notes*, Dec. 28, 1981, at 1567. Similarly, Peggy Musgrave has pointed out: "Proponents . . . [have] suggested that the arm's-length-separate-accounting method is inherently closer to establishing the true source of profits and therefore is less arbitrary than the unitary approach. Such is far from the case. . . . The use of the unitary method as implemented by a factor formula is not perfect, but it places less of a burden on administrative resources . . . , there is less danger of base slippage and discretionary profit shifting . . . and there are fewer items which have to be audited and checked." P. Musgrave, "The U.K Treaty Debate: Some Lessons for the Future," *Tax Notes*, July 10, 1978, at 27, 28.

See also Comment, "Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code," 89 HARV. L. REV. 1202, 1228 (1976): "The unitary entity theory has certain clear advantages. Principal among these is its theoretical superiority as a means for ascertaining the true income of various MNC [multinational corporation] components."

See also Wickham & Kerester, cited in note 8 at 406: "The current Treasury regulation [under section 482] focuses attention on the wrong question; It asks, 'What price is right for intercompany transfers?'

(continued . . .)

Although a formulary system is superior to an arm's length system both in theory and administration, it will not be easy to put into place through the unilateral actions of a single government. Most of the major countries of the world must agree to become part of the solution.[11] Reaching consensus on formulas among the states of the United States has been a protracted process that is not yet completed. But while reaching agreement among the nations of the world will not come easily or quickly, it will not come at all unless the United States takes a leadership role in promoting formulary apportionment.

A First Step: Formulary Apportionment as Part of NAFTA

As an important first step toward worldwide adoption of formulary apportionment, we suggest that the United States work with the governments of Canada and Mexico to establish a formulary apportionment system for the North American Free Trade Zone. Business enterprises operating within NAFTA countries would file consolidated returns showing the total income from those three countries. That income would be allocated among the three member states by formula. We suggest, at least tentatively, that the formula apportion about half of the income from the manufacture and sale of goods to the country of manufacture and the other half to the country of sale.[12] Alternative formulas might be used for allocating income from natural resources and income from services.

To promote formulary apportionment under NAFTA, Congress should encourage the Treasury Department to renegotiate the U.S. tax treaties with Canada and Mexico to allow the use of formulas within NAFTA. The new treaties should also establish a united set of withholding rates, so that remittances from NAFTA to the rest of the world would bear the same tax without reference to the country from which the remittance was made. This uniformity would hugely simplify business operations in NAFTA and would substantially reduce opportunities for tax avoidance and evasion. It also would help generate the understanding and good will that are essential for the long-term success of the NAFTA experiment.[13]

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[10](. . . continued)
The right question is 'What portion of the combined profits or loss derived by all participating units of an enterprise from an international transaction should be geographically sourced to each of the countries claiming jurisdiction to tax part of that income.' "

[11]Contrary to the position sometimes taken by the Treasury Department, agreement on a formula among *all* countries is not needed. Once a critical mass is reached, the members of the formula consortium could simply omit from their formula the sales, payroll and property of nonmember states. For discussion of this so-called "throwout" rule, *see* McIntyre, cited in note 9, at 121.

[12]The formula used by most of the states of the United States apportions about one-third of the income to the country of sale and the remaining two-thirds to the state of production. The fifty-fifty split suggested here in the text could be achieved under the typical state formula by giving double weight to sales. We believe that a fifty-fifty split between the country of production and the country of sale (determined under a destination test) would have political appeal in the NAFTA countries. *See* McIntyre, cited in note 9. *See also* Reuven S. Avi-Yonah, "Slicing the Shadow: A Proposal for Updating U.S. International Taxation," *Tax Notes*, Mar. 15, 1993, pp. 1511-15.

[13]The draft treaty with Mexico negotiated by the Bush Administration does nothing to promote the cause of tax reform or the long-term goals of NAFTA. The Treasury seemed to have had as a major (continued . . .)

The use of a formulary apportionment system under NAFTA would give a major boost to worldwide adoption of a formulary apportionment system. With the disintegration of borders within the European Community, the arm's length standard will become increasingly unworkable for allocating income among EC countries. It is likely, therefore, that the EC would watch the successful implementation of formulary apportionment in NAFTA with great interest.

Conclusion

In the 1960s, the United States government made some important, and we believe mistaken, decisions about how to allocate the taxable income of multinational corporations. Today, with international trade growing ever larger as a share of our nation's economy, we need to rethink those decisions. The pending North American Free Trade Agreement and integration of the European Community make replacing the discredited arm's length system with a simpler and fairer formula approach both more necessary and more likely. We hope that these hearings will help move U.S. policy in that direction.

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[13](. . . continued)
negotiating aim the reduction of Mexican withholding taxes on interest payments to U.S. banks. The proposed reduction will do nothing for the United States or Mexico. It will simply give windfall benefits to a small group of American banks.

Statement of Dale W. Wickham
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&
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presented March 25, 1993 at Public Hearing before the
U.S. Senate Committee on Governmental Affairs
regarding
POSSIBLE NEW DIRECTIONS FOR DEALING WITH TRANSFER PRICING
AND OTHER TECHNIQUES FOR APPORTIONING INTERNATIONAL BUSINSS INCOME.

Topical Summary of Comments & Recommendations

I. Background & Perspective

II. Problems under the Present System

A. *The Core Problems*

1. Lack of rules or vague rules not reducible to numbers required on tax returns.
2. Hypothetical transfer prices.
3. Differing taxation of branches and subsidiaries and lack of meshing of source rules with section 482 rules.
4. Lack of multinational agreement on harmonized apportionment rules.

B. *Derivative Problems*

1. Overburdening of dispute resolution systems.
2. Uncertainty of government revenues.
3. Inability to determine a country's fair share.
4. Potential for overtaxation.
5. Potential for undertaxation.
6. Uncertainty of business' after-tax returns.
7. Enormous compliance costs; two-class justice.
8. Enforcement costs.
9. Disclosure of sensitive information.
10. Disparate treatment of competitors.
11. Discord among nations and between taxpayers and tax authorities.
12. Advance pricing agreement procedures.
13. Heavy taxpayer burdens of proof.

III. Alternatives that are not Solutions

A. More of the same case-by-case approach.
B. Proposed Treasury regulations under section 482.
C. Unilateral measures offer only partial solutions.
D. Illusory international agreements.

IV. Possible New Directions for Solutions

A. Rules reducible to numbers required on tax returns, instead of no rules or illusory rules.
B. Geographic apportionment of a business' combined income (or loss) instead of intercompany transfer pricing.
C. New source rules meshed with section 482 rules.
D. Multilateral agreement on harmonized rules for geographic apportionment.

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NEW DIRECTIONS NEEDED FOR SOLUTION OF THE INTERNATIONAL TRANSFER PRICING TAX PUZZLE: INTERNATIONALLY AGREED RULES OR TAX WARFARE?

by Dale W. Wickham and Charles J. Kerester *

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5 *Tax Notes Int'l* 399 (August 24, 1992)

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I teach law at The American University in Washington D.C., where I am on the faculty of the Kogod College of Business Administration as Distinguished Professional-in-Residence for International & Tax Policy. I have had two articles published recently on various aspects of international transfer pricing and other approaches to apportionment of international business income.[1] Both of these have been made available to Committee Members and staff. I formerly served as an attorney on the Staff of the Joint Committee on Taxation, where I worked on tax treaties and other international tax matters. I served later as Special Counsel to the Senate Committee on Finance for the Tax Reform Act of 1969. I have practiced law in Washington since 1956 with firms which have also had offices in Chicago, New York and other cities. I am currently in my own firm of Wickham & Associates.

This statement and my oral testimony are not submitted to you on behalf of any other person or organization. They reflect my own views. They are based on my work in this area in public service, private practice and academia. I offer them to assist the Committee in arriving at decisions in furtherance of the public interest in this area. The views expressed here are substantially the same as those I presented last July in an appearance as an expert witness I was**

Possible new directions for dealing with problems concerning multinational apportionment of international business income are the focus of this statement to the Committee. Enormous problems are being generated by the arm's-length transfer pricing approach which the U.S. Treasury and the IRS adopted by regulations first proposed in 1966 and finally promulgated in 1968, which they since have advocated for adoption by other countries, and which they still are urging Congress to retain. New directions are needed. I have some to suggest. ~~The bill, H.R. 5270, on which these hearings are being held, has several provisions which would set new directions in this area on which I also will comment.~~

I. Background & Perspective.

My interest in finding solutions to problems in the area really began in 1961 when I discovered while on the Joint Committee Staff that only two of the U.S. income tax treaties then in force had a comprehensive set of bilaterally agreed rules of source to govern which country had the right to tax international business income of non-resident firms or to govern when a country of residence of a firm would be obligated under its foreign tax credit to cede primary jurisdiction to the country taxing income on the basis of its source. At about the same time I discovered that some Treasury and IRS personnel were contending that such apportionment issues should be left to them for disposition on a case-by-case basis under U.S. Internal Revenue Code section 482, and that section should be left vague to operate "in terrorem". Shortly afterwards the House-Senate conferees on the Revenue Act of 1962 agreed to drop from the bill to be sent to President Kennedy a provision in the House-passed version of the bill which would have provided a clearer and more specific form of 3-factor apportionment among commonly controlled units of an international business' income from the sale of goods that would be used unless the taxpayer could demonstrate use of the comparable uncontrolled price method of transfer pricing would be more accurate.[2] That action was accompanied by an expression of hope in the report of the conferees that Treasury would use the power it already had by regulation under section 482 to provide formulary apportionment in lieu of the arm's-length transfer pricing approach. That hope was disappointed when Treasury and the IRS decided in the section 482 regulations proposed in 1966 not to provide any such formulary apportionment but to require use of the less specific transfer pricing approach. That allowed the IRS, after the filing of a tax return, to challenge any method used by a firm under procedural rules which placed upon the taxpayer the extraordinarily heavy burden of proving not only that the IRS' price

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[1] The most recent of these, published yesterday in Tax Notes and entitled " New Directions Needed For Solution of The International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?", was co-authored by Charles J. Kerester of Cleveland, Ohio. Mr. Kerester is a lawyer who is in practice as a member of the firm of Jones, Day, Reavis and Pogue and teaches law as a member of the faculty at the Case Western Reserve University School of Law. He also served as an attorney on the staff of the Joint Committee on taxation, where he worked on tax treaties and other subjects bearing on interjurisdictional apportionment of taxing authority. My earlier article, "The New U.S. Transfer Pricing Tax Penalty: A Solution, or a Symptom of the Cause, of the International Transfer Pricing Puzzle?", was published in the Winter 1991 issue of The International Tax Journal. (at vol. 18, p. 1). While on the Joint Committee Staff I also authored two published reference works on tax treaties--(1) "A Topical Comparison of U.S. Income Tax Conventions (JCT, 1961) and (2) a four-volume "Legislative History of U.S. Tax Conventions" (JCT, 1961)-- and one unpublished analysis and policy critique of U.S. income tax treaties.

[2] The provision was section 6 of H.R. 10650, 82nd Cong., 2d Sess. (1962).

** asked to make before the U.S. House Ways & Means Committee's Subcommittee on Oversight at a public hearing held on H.R. 5270 (102d Cong., 2nd Sess. July 21-22, 1992).

was incorrect but also that it was "arbitrary, capricious, or unreasonable".

II. Problems under the Present System.

Events over the 30 years since Congress' decision in 1962 not to require Treasury and the IRS to permit use of specific factor apportionment provide powerful testimony to the magnitude of the problems connected with adherence to the case-by-case, after-the-fact transfer pricing approach insisted upon by Treasury and the IRS. These problems, which are merely outlined here but discussed further in my recent articles, will only grow larger with increasing internationalization of business and with increasing demands of revenue hungry countries such as the United States for larger shares of taxes on income from international business.

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I believe that the search by this Committee for solutions to problems under the present system can be more to the point and more productive if it is founded on a sharper definition of the problems presented. Congress, and ~~this~~ Committees in particular, have had enormous portions of their available time and resources consumed in recent years by attention to Treasury and IRS recommended alternatives for strengthening the IRS' hand in enforcement of the arm's- length transfer pricing approach. Yet the appropriations requested by the IRS for enforcement in this area and the legislation requested to deal with new problems seem only to increase. I think that the interests of this Committee and of the public will be better served by this Committee's refusal to continue accepting such Treasury/IRS proposals as solutions to the enormous problems presented under the present system. More of the same clearly is not a solution. The newly proposed Treasury/IRS regulations under section 482 also are not a solution; they insist on the costly old transfer pricing approach applied on an after-the-fact, case-by-case basis. The new advance pricing agreement (APA) procedures also are not solutions; they too, insist on case-by-case application of the old transfer pricing approach. The APA procedures also threaten to aggravate the potential for disparate and anti-competitive tax treatment of American business competitors and for unequal treatment of domestic and foreign-controlled international businesses.

A. The Core Problems.

My work has led me to the view that several distinct but related core problems are at the root of difficulties being experienced under the present system. These are the cause of numerous additional problems that can be remedied only if steps are taken to remedy the core problems. Here I will first identify the core problems I see, briefly note their causes, and then discuss some of the additional problems that derive from the core problems, again identifying their causes so that appropriate solutions can be identified. Solutions for some are not solutions for others. There is no single or simple solution.

I note at the outset that *all* of the core problems under the present system are caused by failures of government, not by taxpayer abuse or "evasion" as is so commonly asserted or assumed in discussions of the subject. This means that remedy of these problems can be effected only through governmental actions in those areas.

1. *The lack of rules -- clear rules readily reducible to numbers required on income tax returns.* One central problem permeating the entire area is a lack of clear, definitive rules that are both informative about what is expected and reducible to numbers required on tax returns.

This lack of rules for determining transfer prices, as I pointed out in an earlier article, "was accepted as fact and described at length" by Treasury and the Service in their *1988 White Paper*. It is also noted by the Staff of the Joint Committee at pages 54 and 49 of its explanation of H.R. 5270.

(a) *The lack of rules is caused by failures of government, not by taxpayer "abuse" or "evasion".*

(b) *The lack of clear rules for establishing transfer prices is largely the product of a series of conscious -- and reversible -- choices by tax-policy making officials.*

(c) *The lack of clear rules which are informative about what is expected and reducible to the numbers required on tax returns defeats the U.S. system for voluntary self-assessment of tax in this area of the law. This necessitates a case-by-case, after-the-fact approach and brings other ill effects which pervade the system at all levels.* (See pages 344 - 5 of our article in 56 Tax Notes.)

2. *The requirement of Treasury regulations that hypothetical "arm's-length prices" be constructed for non-arm's length, intercompany transfers for which there are not real prices set by market forces a second core problem that is needlessly generating major problems which are unilaterally remediable through amendment of the regulations.* Superficially, this problem is different from the first core problem having to do with a lack of rules, since here at least there is an explicitly stated rule in the Treasury regulation. This superficial difference, however, often turns out not to be real in practice because of the pervasive lack of comparables (which is not soluble by any new rule requiring comparables), lack of rules for determining what is comparable, and the lack of rules for setting transfer price in the absence of comparables, as we discuss further below. Nevertheless, this core problem in fact is quite different from the general lack of rules. That is because here there is a quite explicit regulatory rule, heavily sanctioned by an array of penalties for its violation, which compels taxpayers, tax collectors, and the courts all to cope with the massive, costly, and often

futile search for third party comparables that is compelled by the rule as we develop further below. The rule requiring the search for comparables also presents major difficulties, beyond money and time costs, that are peculiar to this particular rule.

Another aspect of this core problem which distinguishes it in one very important respect from some of the others is that it can be quickly remedied by unilateral administrative action on the part of Treasury and the Service.

(a) *The focus of Treasury regulations on constructing hypothetical arm's-length prices for non-arm's length, intercompany dealings is a focus on the wrong question, diverting attention from the ultimate questions actually involved.* This is developed at page 344 of our article in 56 <u>Tax Notes</u>.

(b) *The arm's-length pricing approach of the regulations requires a costly search for "comparable" arm's-length prices which frequently do not exist and generally are not reducible to accurate numbers needed on tax returns.*-- Earlier articles have commented at length on the enormous practical and conceptual difficulties presented by the arm's-length pricing requirement of the Treasury regulations.[3] Here I limit myself to noting that some key evidence which was presented in the 1988 Treasury *White Paper* and at the public hearings held in 1990 by the Oversight Subcommittee is reviewed at pages 345 - 7 of our <u>Tax Notes</u> article.

(c) *The complications of the approach requiring "pricing" of intercompany transfers would be eliminated if such intercompany transactions were disregarded as they are for so many other tax purposes.*

(d) *The U.S. Treasury regulations' requirement for arm's length "pricing" of intercompany transfers is not, as a matter of law, required by either the U.S. tax statute or any bilateral tax treaty to which the U.S. is a party.*-- The statutory provisions of section 482 do not require the arm's-length *"pricing"* required by the existing Treasury regulations.[4] In addition, no provision of any tax treaty to which the U.S. is a party requires arm's-length *"pricing"*. The United States had many treaties in place *prior* to publication in 1966 of the proposed Treasury regulation in which arm's-length pricing was first required. None *then or since* expressly required or requires an arm's-length "price." (See page 348 of our article in 56 <u>Tax Notes</u>.)

(e) *The U.S. Treasury Department's reiteration of the contention that its arm's-length pricing standard is the "international norm" erroneously implies that there are no other methods available for implementing an arm's-length standard and fails to recognize that the Treasury Department could take a leadership role in formulating and working to secure international acceptance of arm's-length alternatives to replace a system which obviously is not working.* (See page 348 of our article in 56 <u>Tax Notes</u>.)

3. The differences and lack of coordination between the source rules used by the U.S. for taxation of U.S. unincorporated branches of foreign businesses and allowance of the foreign tax credit for foreign taxes on foreign operations of U.S. businesses and the rules used under section 482 for taxation of incorporated U.S. subsidiaries of international businesses are unjustified and undesirable but are remedial unilaterally. -- A third core problem we see is the use by the U.S. of one set of rules for (a) determining the source of income or loss subject to its tax where international business is carried on directly or through an unincorporated branch and (b) for its allowance of a credit for foreign operations of U.S. businesses and the unjustified use of an entirely different set of rules-- not meshed with geographic sourcing rules-- for making reallocations among entities under section 482 where the business is carried on through an incorporated subsidiary or commonly controlled affiliate. This is recognized in examples presented by the staff of the Joint Committee on Taxation at pages 34 and 35 of their explanation of H.R. 5270. The newly proposed regulations would not change this approach.

4. *Lack of international agreement on substantive and procedural rules for harmonizing and resolving conflicts among competing multinational tax claims to income from international sales of goods and services.* -- A fourth core problem in the area is the lack of international agreement on substantive rules of source for division of profit and loss for income tax purposes, on procedural rules for resolving conflicting multinational interpretations of such rules as they relate both to exercise of a nation's jurisdiction to tax by source and its allowance of a foreign tax credit for another country's taxes on income from sources within that foreign country, and on rules for coordinating or meshing application of source rules with rules for exercise of section 482-type powers.

Here I limit my comment to identifying this as a major problem and to observing that the kinds of issues which must be addressed to arrive at workable source rules for geographically allocating the income tax base appear to be ones that can supply the more specific standards needed to reduce vagueness of the rules for the exercise of the section 482-type powers and to coordinate those with the source rules.

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[3] Wickham, *Transfer Pricing*, *supra* note 1, at 10-19; Langbein, *"The Unitary Method and the Myth of Arm's Length"*, 30 Tax Notes 625 (Feb. 17, 1986).

[4] Prior to their issuance in 1968, the predecessor regulations since 1934 did not require an arm's-length price. They did require an arm's-length standard, but not an arm's-length price. Article 45-1 of Treas. Reg. § 86. An arm's-length "standard" does not require an arm's-length "price." The latter is the requirement imposed by the Service and Treasury, first in proposed regulations under section 482 in 1966 and then in final regulations adopted in 1968. The provisions of section 482 or provisions corresponding to it in earlier years were in place since at least the 1928 Act. The earliest version originated in the Treasury regulations in 1917. Treas. Reg. §41, Articles 77 and 78. The regulations were codified by section 1331 of the Revenue Act of 1921.

B. Derivative Problems

Several other problems under the present system are consequences of the core problems just described. Here I will merely identify some of these derivative problems, referring you to our article in 56 Tax Notes at the pages noted here for further discussion of most of them.

1. *There is an overburdening of systems for resolution of tax disputes*, both in the United States system for resolution of tax controversies and in the meager international structures provided under bilateral tax treaties for competent authority proceedings. (56 Tax Notes 349.)

2. *The lack or vagueness of rules prevents governments from making reasonably accurate estimates of revenues they may expect from income taxation of international business transactions.* This applies to forecasts of income tax revenues a government can expect from (a) exercising its power under section 482 (or a foreign equivalent) and (b) from discharging its statutory or treaty obligations under the foreign tax credit to cede some of these revenues to foreign countries of source. The resulting inability of government to predict with reasonable accuracy the revenues it may expect to derive and keep from international business transactions has multibillion dollar budgetary implications for the United States. Overestimation of revenues from international business transactions leads to overestimation of revenues needed from other sources. These budgetary implications will only grow larger as the level of international business activity increases or as the measure of vagueness of the rules increases.

3. *There is the inability of the U.S. and other nations to know whether each is getting its "fair share" of tax revenues from international business transactions.*--The issue of "fairness" of a country's share of such revenues has a potential for causing major difficulties in international relations. Such difficulties may take the destructive form of multinational tax warfare in which one country's punitive or discriminatory taxation of foreign-controlled businesses provokes the foreign country's retaliatory taxation of businesses controlled by residents of the first country. More than the absolute level of tax revenue is involved. Widely and deeply held concepts of political and economic justice and equity and fair play are also involved. Americans may see the issue, for example, in terms of whether foreign-controlled businesses "exploiting" the U.S. market are paying taxes on the fruits of their endeavors which correspond to the tax burdens of Americans. Such views may translate into political pressures on elective U.S. government officials to raise needed U.S. revenue from the politically "low-cost" source of foreigners who do not vote in U.S. elections. U.S. political leaders and would-be leaders would be well advised, however, to remember that the fervor of Americans' reaction to "taxation without representation" may be mirrored in the reactions of people of foreign countries in which U.S.-controlled firms do business. The same U.S. government officials who are pressed by their citizenry to tax foreigners may also find themselves pressed by their U.S.-controlled business firms to advocate the latter's interests in "fair" and non-discriminatory tax treatment by foreign governments[5].

Answering the question whether a country is getting its "fair" share of revenues from income taxation of international business transactions requires more than unilateral actions on the part of each country competing for a share of that revenue. Each competing country may unilaterally make and enforce its own rules as to the amount of tax it may seek from an international business, on grounds either that the business is locally domiciled or that the geographic source of the income is local. The tax declared due under those unilateral rules, however, is only a declaration of that country's position, which may or may not be considered by foreign countries involved to be a "fair share". Fairness of national shares of revenue from multinational income taxation of business transactions can be settled only by reference to factors in rules which are either agreed to by the several countries involved or are set by judicial or other arbitrators agreed to by those countries.

The fact is that such internationally agreed rules are generally lacking. U.S. tax rules for exercising its power under section 482 to reallocate taxable income from foreign to domestic U.S. entities are not rules for geographically sourcing such income among competing countries. Source rules used by the U.S. for that purpose are separate from, and not coordinated with, the U.S. rules for exercise of its powers under section 482, which generally are applied unilaterally and frequently without regard to positions on issues of geographic allocation taken even by the U.S. itself let alone by other countries. (See 56 Tax Notes 350.)

There is a need for all responsible agencies of government in the U.S. and abroad to work constructively and cooperatively to supply the framework of internationally agreed rules needed for multinational income taxation of international business transactions. That course offers a promise of international tax harmony rather than international tax warfare.

4. *There is the potential for multiple over-taxation of international business transactions, with the consequent depressing effect that may have on the free flow of such transactions in reference to free market forces of supply and demand.* (See 56 Tax Notes 351.)

[5]Responsive to such concerns, Congress long ago enacted provisions of U.S. income tax law which authorize the President to institute retaliatory taxation of foreign nationals of countries found by the President to have imposed taxes which are "more burdensome" or "discriminatory" against U.S. nationals. See I.R.C. §§ 896 and 891.

5. *There is also the potential for under-taxation of international business transactions* that was the focus of the both the 1990 and the 1992 hearings of the House Oversight Subcommittee. (See 56 Tax Notes 351.)

6. *There is the inability of businesses to predict with reasonable certainty the levels of taxes and after-tax returns they may expect from international business transactions.* (See 56 Tax Notes 351.)

7. *There are the truly momentous costs for taxpayer compliance and the potential for a 2-class system of tax justice for large businesses and small businesses.*-- Fees that international business firms must pay private sector professionals for work on a large transfer pricing tax case can be enormous. (See 56 Tax Notes 351.)

This burden is one that could scarcely be afforded by small businesses attempting to follow the proposed regulations. While a larger enterprise may be able to better afford such costs, it is hardly in the interest of such a larger enterprise or the public to require the enormous expenditure of resources, public and private, that continuation of the existing state of affairs would require.

8. *There are momentous costs and needless waste of scarce governmental resources for enforcement and administration of the present case-by-case approach.* Neither the total costs incurred nor the revenue benefits received by the U.S. government in connection with administration and enforcement of the Treasury's current or proposed arm's-length pricing regime under section 482 have ever been published by the Service or Treasury, so far as I am aware. Fragmentary elements occasionally are reported. However, no report is made of such costs and benefits on a system-wide basis covering all the costs of section 482-connected operations of all units of the U.S. government that are involved. Moreover, the Service and Treasury questionably determined that the proposed regulations under section 482 are not "major rules" for which a cost/benefit Regulatory Impact Analysis is required under Executive Order 12291.[6]

I note that the President recently extended his 90-day freeze on most new regulations by four months, and ordered government agencies to start using new cost-to-benefit analyses when evaluating legislation or proposed rules.[7] I suggest that those requirements be applied to the Service and Treasury and that they determine and account publicly for the costs of adhering to the present case-by-case approach under section 482. More specifically, I suggest that the Service and Treasury be required to report to the Office of Management & Budget, the Congress, and to the public on the annual and cumulative dollar costs of the Government (including the Service, the Treasury and the Justice Department) for administration and enforcement of section 482. The system-wide costs thus determined for administration and enforcement of the present case-by-case approach under section 482 should then be compared with the costs that could be expected under a new system of generally applicable rules reducible to numbers required on tax returns. Without having done all the work described to make an appropriate cost/benefit analysis, we think the evidence already available strongly suggests that a comparative cost/benefit analysis would argue for replacing the present case-by-case approach with a new system which provided pre-published rules of general application that are reducible to numbers needed on tax returns.

9. *There is the dependence of the system on disclosure by taxpayers, and by competitors and other third parties, of confidential financial and sensitive business information that needlessly generates enormous difficulties.* These difficulties include (a) the high cost of litigation and other efforts to acquire such information; (b) breach of the information suppliers' confidences; (c) the use of evidence not subject to a taxpayer's cross examination; and (d) the demand for information about competitors' pricing and internal affairs which if directly sought by conscientious taxpayers' executives through communications with competitors representatives would, we are advised by anti-trust counsel, risk criminal violation of section 1 of the Sherman Antitrust Act.

10. *There is a very real potential for disparate and anti-competitive tax treatment of business competitors* implicit in any tax regime that is reliant not on published and principled rules of general applicability but on a case-by-case approach liable under which the tax exacted in each case is set by revenue officials without the guidance of such generally applicable rules. This potential is aggravated by the new advance pricing agreement procedures as I note further below.

11. *The potential of the present system for fostering an atmosphere of mutual distrust and growing discord between tax authorities and taxpayers and among nations is needless.* Recent events indicate the potential of the present transfer pricing tax system for generating discord, both internally within the United States and internationally. (See 56 Tax Notes 353.)

The potential of the present system for domestic partisan discord and for destructive international tax warfare could hardly be more vividly indicated than by the *Wall Street Journal's* recent headline about a U.S. presidential candidate's prioritizing U.S. operations of foreign-controlled business

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[6] *IRS/Treasury Notice of Proposed Rulemaking*, 57 Fed. Reg. 3571 at 3578 (proposed Jan. 30, 1992).

[7] *Wall St. J.*, April 30, 1992, at A-2. *Also see 84 Daily Tax Report* (BNA) G-13 (April 30, 1992).

enterprises as targets for income taxes needed to reduce the U.S. budget deficit. The same is true of sections 304 of H.R. 5270 which would impose a minimum U.S. "income tax" on gross receipts of U.S. operations of businesses controlled by foreign interests, whether or not the foreign parent and its U.S. subsidiary together show a combined profit or loss, and irrespective of whether that violates international tax treaty obligations of the United Stated against discriminatory taxation of foreign treaty partner business enterprises.

12. *The problems added by the new advance pricing agreement procedures: taxation by secret negotiation and agreement instead of by pre-published rules of general application is not consistent with U.S. traditions.*--Last year Treasury and the Service instituted, with great fanfare, the new advance pricing agreement procedures for use in this area. (See 56 Tax Notes 353.)

What do the new APA procedures not do? This may be answered by testing APA's in the light of their tendency to resolve the core and derivative problems under the present system we have described earlier in this paper. They do not abandon the case-by-case aspect of the Service's approach; instead they insist on it. They fail to supply the pressing need for pre-published rules of general and equal application to *all* taxpayers. They thus deprive all people and countries subject to the present arm's-length transfer pricing tax regime of the enormous benefits to all that can flow from a system for voluntary taxpayer self-assessment of tax. The Service's publication of some generic guidelines with respect to the advance pricing procedures, as the Commissioner and the *1992 Treasury Report* promise, would be modest steps in the right direction. However, guidelines are no substitute for clear, pre-published and generally applicable principles of law. The advance pricing process will still be a case-by-case approach, reminiscent of the experience under the 1968 guidelines under an earlier version of section 367, which requires an enormous expenditure of resources to follow an errant policy.

The APA procedures also fail to designate acceptable methods, from among several available, as alternatives to the costly arm's-length pricing method for assigning to countries and taxpayers the profits (or losses) realized by a controlled group in its arm's-length international transactions. They divert limited time and energy of tax policymakers and enforcement personnel away from endeavors that promise far greater public return on the investment. The international tax counsel of General Electric Co. was quoted recently as saying that while advance pricing agreements will help some taxpayers reduce uncertainty, they are not practical for relatively large companies. He reportedly advised that G.E. alone, which has 13 affiliates worldwide, "would keep the government busy for the rest of the century if we pursued APAs."[4]

What are the additional problems generated by the new APA procedures? Because they apply case-by-case and are so time-consuming and costly for taxpayers and governments, they can only aggravate the disparities and lack of even-handedness in treatment of taxpayers that is inherent in any case-by-case approach not guided by rules of general application. Winners will be found only among the relatively small number of larger business taxpayers who can afford the costs, while the losers will include the vastly larger number of smaller business taxpayers who cannot afford the costs of this and are deprived of the benefits of pre-published rules of general application.

Even more seriously, however, the new APA procedures are secret, enhancing the potential for disparate treatment of competitors and for unequal application of our tax laws as between domestic and foreign-controlled international businesses. Advance pricing agreements are the result of secret negotiations between taxpayers and tax collectors, and meetings between countries' taxing authorities from which interested taxpayer representatives are excluded, in proceedings that may involve sums that are large for all parties. While advance pricing agreements may provide a given taxpayer some measure of certainty for a limited period of years and for the transactions in products subject to that agreement, they provide no guidance to the rest of the world as to the applicable principles of law. Such secret agreements, coupled with the absence of published principles of law, result in *ad hoc* agreements that in turn create the potential for disparate treatment of competitors. Would it be acceptable for the Service to enter into advance agreements about methods of pricing for income tax purposes one line of motor products sold by Chrysler Corporation while it does not do so for competing lines of motor vehicle products sold by Ford Motor Company or by Toyota? If not, how under the present system would any independent authority be able to monitor such activity of the Service? We ought not repeat the course of action rejected by the Court of Claims in the IBM *case*,[5] where the Service granted one company a favorable excise tax ruling that it denied a business competitor for competing products.

Adoption and advocacy of the new APA procedures amounts to a Service invitation to large international business taxpayers, "Let's make a deal, a secret deal, about the method to be used for determining your income taxes." That undercuts the appearance of integrity and even-handedness that is so vital to public acceptance of, and voluntary compliance with, our tax laws.

This problem is especially aggravated when senior Treasury and Service tax officials publicly comment on the high tax penalties and other costs that may be suffered by taxpayers who fail to avail

[4] Remarks of Mark Beam in New York City on April 27, 1992, as reported in *1 Tax Management Transfer Pricing Report* 4, at 25 (May 1, 1992).

[5] *International Business Machines v. United States*, 343 F.2d 914 (1965).

themselves of the benefits the new APA procedures can offer. Taxation by secret negotiation and agreement instead of by pre-published rules of general application is not the tradition in this country and does not comport with its democratic political values.

We also strongly urge that the Service, without waiting for such new principles of law, be compelled legislatively to publish sanitized versions of *all* APAs from which confidential and sensitive business information has been removed as is done with private letter rulings of the Service. However, publication of sanitized APAs can only be a stop-gap measure and is not a substitute for adoption of pre-published rules of general application.

13. *Problems in requiring taxpayers to bear the extraordinarily heavy burden of proving the Service's arm's-length pricing adjustments to be arbitrary, capricious or unreasonable.* (See 56 Tax Notes 353.)

III. Alternatives that are not Solutions.

A. The present case-by-case approach of the U.S. is a problem to be solved, not a solution, and neither it nor the many new measures adopted for its enforcement can be a substitute for clear and pre-published rules of general application that are reducible to numbers needed on tax returns.
(See 56 Tax Notes 353.)

For such reasons, we submit that the U.S. Congress, U.S. citizens, and trading partner countries' government and citizenry should reject the U.S. Internal Revenue Service's quest for the power to continue its adherence to a case-by-case approach to the exaction of income taxes in this area. We simply can't afford it. Procedures for advance pricing agreements, programs for stepped-up enforcement activities in audit or in litigation, programs for intensified information reporting or exchange of information among taxing authorities, cannot function as substitutes for the principled new rules of substance that are so badly needed in this area. I recommend that senior U.S. Treasury Department officials, the President, and the U.S. Congress join in rejecting the Service's request for no legislative action to implement sorely needed solutions to the costly problems in this area. As grounds for not taking such action, the Service has urged that time be allowed to field test the results of the new enforcement money and powers it has requested and been granted to proceed on a case-by-case basis. I believe that such grounds should be rejected. We don't have to spend years of empirical field testing and millions if not billions of dollars to know that the Service's case-by-case approach is a problem that the public interest requires to be solved, not embraced.

B. Proposed new Treasury regulations under section 482, intensify rather than solve problems.

In their presentations to the House Oversight Subcommittee at the hearings held in April of this year and in their simultaneous report to the Congress on section 482, Treasury and Service policymakers cited their newly proposed substantive regulations as one of their administrative steps for enforcement of section 482 which would make "[a]dditional legislative changes . . . premature at this time."[10] I disagree. As I have developed earlier, the proposed regulations do not even purport to solve the core problems that are at the root of the major difficulties being experienced in the area. We suggest that statements or implications to the contrary should be dismissed by Congress. They instead should be viewed instead as a declaration by Treasury and the Service of their intention to continue their costly insistence on permitting only their arm's-length pricing standard to be used.

C. Unilateral measures offer only partial solutions.

As we have noted earlier, some of the major problems under the present system can be remedied by unilateral action. Thus, we have noted a number of administrative or legislative actions that could be taken unilaterally by the Untied Stated which could effect important reductions in the high level of difficulties now being experienced. As we have also noted, however, some of the problems under the present system are soluble only by international agreement. This is particularly true with respect to issues concerning "fairness" of the share of revenues derived by each of two or more countries competing for taxation of income from the same international business transactions. Accordingly, international agreement among competing taxing jurisdictions is required to secure more than a partial solution to conflicts among countries' substantive or procedural rules pertaining to allocation of the base for taxing income from international transactions. That is true whether the rules involved relate explicitly to exercise of jurisdiction to tax income on the basis of local source, to a domiciliary country's obligation to cede primary jurisdiction to another country of source by allowance of a credit against tax of the domiciliary country for tax of the source country, or only indirectly but nevertheless actually to a domiciliary country's exercise of a section 482-type power to reallocate taxable income to business units that are taxable as domiciliaries in a manner which conflicts with international rules prescribing geographic source of that income.

To some this point is obvious; to others it is not. Perhaps that is because of a habit in the United States for so many years of thinking only in terms of what the U.S. can do legislatively or administratively to change its approach to international businesses subject to the U.S. tax. Whatever the reason, the result is that proposals often are put forward as alternatives for solving problems in this area

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[10] *1992 Treasury Report*, at "Executive Summary", item (c).

without recognition that they can be only partial solutions to problems which require international agreement. This is true, for example, of those proposals relevant to transfer pricing that are in the *H.R. 5270* that are aimed at assuring the U.S. its "fair share" of income tax from international business transactions. Our tax policy-makers in the United States need to understand that there are distinct limits on what can be accomplished by just talking to ourselves. We must also talk with our trading partners if we are interested in establishing internationally agreed standards for determining the fairness of respective national shares of the international income tax base.

D. International agreement on rules which are illusory and not readily reducible to numbers required on tax returns is not a solution.

An agreement is not effective to bind the parties and is not enforceable if the subject matter of the agreement does not exist. The agreement is illusory. Obviously, an international agreement to divide taxing rights by reference to a comparable arm's-length price is similarly illusory if the comparable does not exist, or if it exists but cannot be found. Similarly, an agreement is not effective to bind the parties and is not enforceable if it is so vague or ambiguous in meaning that arbitration authorities are unable to accord the language of the agreement an interpretation that can be reduced to practice in a way the parties can fairly be said to have intended. The considerations just noted are relevant not only to the binding status of Treasury's arm's-length pricing interpretation of international agreements now in place but also to objectives to be set regarding the content of new international tax agreements that are to be sought. To be effective, an international agreement to divide rights to taxation of income from international business transactions should operate by reference to existing and known factors that are reducible to numbers required on income tax returns.

IV. Possible New Directions for Solutions

Generally, the new directions we suggest to reduce problems in the area require a shift in the U.S. policies to be pursued with respect to each of the core problems we have identified above.

A. *Rules instead of no rules or illusory rules* -- Shift away from a system having intentionally vague, "in terrorem" rules or no rules at all to one which prescribes definitive rules that are readily reducible to numbers required in tax returns.

Preferably, the task of providing needed rules would be accomplished to the maximum extent possible through actions by Treasury and the Service to amend regulations under section 482, to publish necessary revenue rulings and revenue procedures, and to pursue international consultations -- all within time constraints commensurate with the urgency of the problems presented. The Congress is neither equipped nor constitutionally positioned to take the administrative actions described or to obtain the ensuing multinational agreements that are needed. However, if Treasury and the Service fail to act Congress should set deadlines and enact legislation implementing clear and workable rules that would be an appropriate starting point for an internationally harmonized regime.[11] Congress took action with respect to section 367 to negate the case-by-case approach under section 367. If there is a continued failure by Treasury and the Service to abandon the case-by-case approach under section 482, Congress should take corresponding action as needed with respect to rules under section 482.[12]

B. *Abandon intercompany transfer pricing, focus on geographically apportioning combined income or loss* -- Shift away from requiring focus on what "price" is right for intercompany transfers; instead, disregard such intercompany transfers and concentrate on geographically allocating combined profit or loss actually realized by a controlled group from arm's-length transactions with uncontrolled parties.

The new substantive rules adopted by the United States should abandon that aspect of the approach in the current and in the proposed regulations under section 482 which requires an attempt to establish a hypothetical tax price for non-arm's-length, intercompany transactions among members of a commonly controlled group of business enterprises or a constructive operating profit for a given party selected as the tested party under the proposed regulations[13] These new rules at the very least should *permit* use of other arm's-length methods which do not require resort to comparables or construction of hypothetical prices for intercompany transactions. That change alone would do more than perhaps any other single action to reduce mounting problems in the area, and it can be unilaterally and quickly effected by the U.S. Treasury Department and Service by amending the pending proposed regulation. The new U.S. rules should permit and

[11] We do not share the view recently attributed to former Assistant Treasury Secretary Gideon that Congress has few alternative courses of action other than a formula approach. 1 *Tax Management Transfer Pricing Report* 5 at 6 (May 13, 1992). We think it would be preferable for Treasury to lead the way. If it continues not to, however, we think there are many options open to Congress for using its powers to correct directions of the U.S. policy in this area to move toward more workable methods for geographic apportionment.

[12] *See*, for example, the comments of Patrick Heck, House Oversight Subcommittee Assistant Counsel, made before a conference of the American Tax Institute in Europe held in Paris, reported in 114 *Daily Tax Report* (BNA) G-1&2 (June 12, 1992).

[13] This does *not* mean that an arm's length standard for determining profit or loss should be abandoned. Taxable profit or loss is commonly determined by tax accounting methods which disregard transactions among related parties and take account only of transactions at arm's length.

define methods for determining and then allocating to countries of source the combined arm's-length profit or loss actually derived by the participants in a controlled group from an external international business transaction (or series of transactions) concluded at arm's length with an unrelated third party.[14] The new rules should authorize a split of the participants' actual (as distinguished from a constructive) arm's-length profit or loss, using for the split definitively specified and weighted factors from among rules of source described further below. The rules used would fix the geographical locale of the particular business activities, assets, personnel markets, and other factors on which the country bases its claim to tax a portion of the income generated by that business.

C. *New source rules* -- Focus on developing a single, new set of unified source rules for geographically allocating profit or loss on terms that are the same for a business whether conducted through its branches or incorporated subsidiaries and are meshed with rules under section 482 for reallocation of income among entities.

The United States should act unilaterally to adopt one set of new, substantive source rules, properly meshed with entity reallocation rules under section 482, for determining the portion of net income or loss from an international business transaction (or series of such transactions) that it will consider properly allocable to various countries having contact with a transaction.[15]

<u>Recommended Criteria for New Source Rules</u>[16] The new substantive rules adopted by the United States for determining geographical source should relate to all types of income and expenditure entering into determination of net profit or loss. The new rules should provide operating rules to resolve difficult classification questions that frequently arise regarding the particular source rule that is to govern allocation of that item. The new rules should apply to fix geographical source for purposes of (i) a country's exercise of jurisdiction to tax on the basis of source, (ii) its allowance of credit for another country's tax on income from sources in the other country, and (iii) its exercise of 482-type powers to reallocate income to an entity it taxes on the basis of nationality or domicile. The new rules should allocate the combined net income (or loss) of the controlled group from each transaction with an independent third party by reference to a set of specific factors whose relative weights are specified and whose meanings are sufficiently clear to be reducible to numbers required on tax returns. The factors should call only for financial data that should be readily available to any properly managed business.

Unlike many of the existing U.S. source rules, the new rules should focus not on legal formalities but on the geographic locale of the business activities, assets, personnel, markets, and other factors that are actually involved in producing the business income or loss to be allocated. These criteria should prevent taxpayers --or taxing authorities --from fixing source by reference to arbitrary factors which lack economic reality and which are open to manipulation for tax purposes. Thus, we suggest that the factors so far as possible ignore legal formalities, such as place of passage of legal title to goods or place of in corporation or organization of a business, which are open to manipulation for tax purposes. The factors also should not include ones that are unlikely to be acceptable by other countries as a reciprocally applicable standard for geographic allocation of the international income tax base. In other words, the new rules also should have a realistic prospect for gaining international acceptance by other countries, especially those that are major trading partners of the U.S. U.S. source rules which fail to take account of major revenue and internal political interests of trading partner countries are likely to foster international conflict and double taxation and to be unstable due to their failure to do their job.

D. *Multinational agreement on harmonized source rules* -- Focus on formulating and obtaining the

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[14]This approach is used in a limited context in section 203 of H.R. 5270. The suggested concept of treating an entire controlled group as a single entity for such a single purpose is hardly new to the tax law. There already are various provisions under which (i) interest expense, (ii) all expenses (other than interest) which are not directly allocable or apportioned to any specific income producing activity, and (iii) certain research and development expenditures, are to be determined, allocated and apportioned as if all of the members of an "affiliated" group were a single corporation. *See* I.R.C. §§ 163 (j)(6)(c), 864(e)(1) and (6), and 864(f)(4). This suggestion is also analogous to the approach used in determining the combined taxable income from a given transaction of a foreign sales corporation (FSC) or the earlier domestic international sales corporation (DISC) and its related supplier. *Also*, section 101 of H.R. 5270 provides that taxpayers may take into account the interest expenses and assets of *foreign* subsidiaries for purposes of allocating and apportioning interest expenses between gross income from U.S. sources and foreign sources.

Further, section 201 of H.R. 5270 would generally repeal deferral on controlled foreign corporations by treating as subpart F income generally all of a controlled foreign corporation's earnings and profits for the taxable year.

The Service *already* has the powers to require foreign as well as domestic entities to report the information and to furnish the records that are needed to audit the combined taxable income or loss reported by the taxpayer. *See, e.g.*, I.R.C. §§6038, 6038A, 6038B and 6038C.

[15]Section 203 of H.R. 5270, would do that in a limited context for U.S. tax purposes.

[16]We do not attempt here to state specific substantive terms for all the modified new source rules we recommend. We think that requires completion of a substantial amount of research work (especially on foreign laws and practices) and international consultation which has not yet been accomplished. Dale Wickham has begun work on a collaborative research project looking to formulation of a draft international agreement which will provide proposed substantive rules for geographic allocations to source and procedural rules for resolving issues among countries which arise in interpretation and application to specific cases of the substantive sources and related rules concerning a party country's exercise of jurisdiction to tax international transactions. Lacking the product of the considerable work required in that project, we limit ourselves here to general criteria we recommend for modified new source rules.

needed multinational agreement on rules for harmonizing and resolving conflicts among competing multinational tax claims to income from international sales of goods or services, especially (a) substantive treaty rules for geographically sourcing or allocating profit (or loss) among competing tax jurisdictions and (b) procedural treaty rules establishing a framework for resolving conflicts among multi-national interpretations and applications to specific cases of substantive sourcing and jurisdictional rules.

The United States should take the initiative to formulate and to secure multinational agreement to a single new set of definitive rules for geographically allocating to source any income or loss derived from an international business transaction or series of them, including arm's-length income or loss derived by a controlled group from transactions involving two or more members of a commonly controlled group. Preferably, this would be accomplished through a single, multilateral treaty to which agreement would be sought by all nations having significant international business transactions and which would enter into force with respect to each signatory country as it agrees. However, if no other route is feasible, this could be done through a network of bilateral tax treaties, or even through international executive agreements for implementing reciprocity as to source rules. The Treasury Department should pursue this objective by developing a new draft treaty to provide source rules of the kind described, after appropriate consultations with representative tax officials of countries which are trading partners of the United States, and through appropriate channels should request the OECD and the United Nations to initiate similar work.

Any model treaty and any multilateral or bilateral treaty provide (i) for binding arbitration to resolve any disagreements between two competent authorities and (ii) for the publication of the arbitrator's decision and reasoning. Any such treaty should also provide that a taxpayer requesting the assistance of competent authorities has the *right* to participate in the deliberations with the competent authorities of any other jurisdiction involved in the dispute. Members of the European Community have agreed to a convention that provides for binding arbitration.[17] The new income tax treaty between Germany and the United States provides for arbitration, but not for binding arbitration.[18] The decisions of some international tribunals or bodies are made public. That includes the decisions of the International Court of Justice and the decisions of the Iranian - United States Claims Commission. Sunshine can be therapeutic. It imposes a certain discipline on all concerned. It should be emulated, not shunned.

Any such treaty should also provide (i) that the decision and the reasoning of the competent authorities be made public; and (ii) that any failure to reach agreement be reflected in a published document.

Our recommendation of a multinational agreement is certainly not new. It was made in December, 1965, even before the then proposed regulations were issued in 1966, by the Treasury's Assistant Secretary for Tax Policy, Stanley Surrey.[19]

In August 1990, the United Kingdom, through its then Chancellor of the Exchequer and Prime Minister John Major, invited the United States to join in seeking multilateral rather than unilateral solutions to problems of possible tax avoidance by multinational corporations; and not long afterward U.S. Treasury Secretary Brady announced U.S. acceptance of that invitation from the United Kingdom as well as a similar invitation from representatives of West Germany.

We believe that the enormous amount of time and effort now devoted to implementing the advance-pricing agreements and that will be necessary to attempt to collect the third party information necessary under the proposed regulations or on audit, in a continuation of a case-by-case approach would be better spent in reaching agreement with the tax authorities of other countries in a multilateral treaty on the geographic source of income, to thereby provide greater certainty, in advance, to all taxpayers and governments. The time and effort now devoted by the Service or Treasury personnel to persuading a given foreign tax authority to agree on a single advance-pricing agreement applicable to a single taxpayer and members of its control group for a limited period of years could and should be directed instead to reaching agreement on source rules applicable to all taxpayers and to all governments involved.

The U.S. Treasury Department has the opportunity to take the initiative, to seek a multinational agreement on the geographic source of income. It should seize that opportunity. A unilateral approach will not suffice.

DALE W. WICKHAM

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[17]Section 3 of the "Convention on the Elimination of Double Tasation in Connection with the Adjustment of Profits of Associated Enterprises." 33 Official Journal of the European Communities 19, L225/10 (90/463 EEC)(August 20, 1990). *See* in particular Articles 7 and 12 of section 3. All 12 member states of the EC signed it. Each must ratify it under its respective ratification procedures. Under Article 18, the convention will enter into force on the first day of the third month following that in which the instrument of ratification is deposited by the last signatory to ratify it. *See* John Turro, "EC Arbitration Treaty to Provide Solution to Transfer Pricing Disputes," *3 Tax Notes International* 479 (May 1991).

[18]*See* Article 25(5) of that treaty. Convention for the Avoidance of Double Taxation, Aug. 29, 1989, Germany - U.S., Art. 25(5), __ T.I.A.A __, S. Treaty Doc. No. 101-10, 101st Cong., 2d Sess. (Feb. 5, 1990)

[19]*See* our article in 56 Tax Notes 339, at 361.

Rept of W&M Com. Rept No. 1447 p. 58, [illegible]

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VII. ALLOCATION OF INCOME BETWEEN RELATED FOREIGN AND DOMESTIC ORGANIZATIONS

(Sec. 6 of the bill and sec. 482 (b) of the code)

A. Reasons for provision

Under present law, foreign corporations which are controlled by domestic corporations or other persons are not taxed by the United States on their foreign source income. Thus, United States imposes no tax with respect to the profits of such a corporation when they are earned although it does impose a tax on the domestic shareholders of this corporation when they receive dividend distributions from it. This taxation at the time of distribution, rather than at the time the income is earned by the foreign corporation, has become known as "tax deferral." U.S. corporations, it is believed may sell goods to their controlled foreign subsidiaries at less than a fair price to avoid a U.S. tax on what should be their full profit for such sales. Similarly, in other cases it is believed that foreign-controlled subsidiaries have sold goods to their domestic parent at more than the fair market price. The effect of such transactions is to understate the taxable income of the domestic corporation subject to U.S. tax and to overstate the income of the foreign subsidiary. Thus, to the extent the U.S. tax rate is above that imposed by the foreign country or country involved, tax deferral is achieved with respect to this diverted income during the period of time the income is held abroad. The Secretary of the Treasury, in his testimony last year on this subject stated:

> This is not simply a question of allocating the profits of foreign operations to tax haven countries. It is a problem that significantly affects U.S. taxation of domestic profits The technique that is used for diverting profits from one company to another among European affiliates is also used to divert income from U.S. companies to foreign affiliates. Income that would normally be taxable by the United States is thrown into tax haven companies with the object of obtaining tax deferral. This is done, for example, by placing in a Swiss or Panamanian corporation the activities of the export division of a U.S. manufacturing enterprise. A very substantial volume of exports is required merely to offset the loss in foreign exchange which the retention abroad of export profits entails.

Present law in section 482 authorizes the Secretary of the Treasury to allocate income between related organizations where he determines this allocation is necessary "in order to prevent evasion of taxes or clearly to reflect the income of any such organizations." This provision appears to give the Secretary the necessary authority to allocate income between a domestic parent and its foreign subsidiary. However, in practice the difficulties in determining a fair price under this provision severely limit the usefulness of this power especially where there are thousands of different transactions engaged in between a domestic company and its foreign subsidiary.

Because of the difficulty in using the present section 482, your committee has added a subsection to this provision authorizing the Secretary of the Treasury or his delegate to allocate income in the

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case of sales or purchases between a U.S. corporation and its controlled foreign subsidiary on the basis of the proportion of the assets, compensation of the officers and employees, and advertising, selling and sales promotion expenses attributable to the United States and attributable to the foreign country or countries involved. This will enable the Secretary to make an allocation of the *taxable income* of the group involved (to the extent it is attributable to the sales in question) whereas in the past under the existing section 482 he has attempted only to determine the fair market sales price of the goods in question and build up from this to the taxable income—a process much more difficult and requiring more detailed computations than the allocation rule permitted by this bill.

The bill provides, however, that the allocation referred to will not be used where a fair market price for the product can be determined. It also provides that other factors besides those named can be taken into account. In addition, it provides that entirely different allocation rules may be used where this can be worked out to mutual agreement of the Treasury Department and the taxpayer.

B. General explanation of provision

The bill adds a new subsection (b) to the provision of existing law (sec. 482) authorizing an allocation of income between corporations (or other persons) controlled directly or indirectly by the same interests. The new subsection applies only to sales of tangible property within a group where one of the organizations is domestic and another is foreign (however, there may be more than one domestic or more than one foreign organization involved) but only where the organizations are owned or controlled directly or indirectly by the same interests. In such cases the Secretary of the Treasury or his delegate is authorized (but not required) to allocate the income of the group arising from these sales under the allocation rule described below. Nevertheless, this allocation rule is not to apply where the taxpayer can establish an arm's-length price for the goods in question

Under the general allocation rule provided by the bill the Secretary or his delegate is to allocate the income between the United States organization and the foreign organization on the basis of the proportion of the assets, the compensation of officers and employees and the advertising, selling and sales promotion expenses of the group which on one hand are not attributable to the United States and which on the other hand are attributable to the United States. For this purpose, only those assets, that compensation and those sales, etc., expenses which are attributable to the property so sold or purchased are to be taken into account.

The allocation need not be based upon the above-mentioned factors alone. The provision specifically authorizes the inclusion of other factors such as special risks, if any, of the market in which the product is sold. In addition, if the taxpayer or the Secretary or his delegate can work out some other mutually agreeable method of allocating income, this alternative method is to be used instead of the rule referred to above.

Generally, the value of the assets to be taken into account in the allocation method is to be the adjusted basis of these assets in the hands of the taxpayer. However, in the case of some foreign corporations, a U.S. concept of adjusted basis for assets may be difficult,

if not impossible, to compute. In such cases, their book values may be used, adjusted to the extent feasible to approximate adjusted basis. The assets to be included in this allocation formula are real property and tangible personal property except inventory and stock in trade. In addition, real property and tangible personal property which are rented are to be taken into account for this purpose.

As indicated previously, the allocation method described above is not to apply to any sale where the taxpayer can establish an arm's-length price. An arm's-length price for this purpose can be established under either of two procedures. First, the taxpayer can determine the arms-length price by establishing the price at which similar or comparable property is sold in the same general marketing areas to unrelated persons either by the taxpayer or by third parties, if the conditions of sale are similar. Second, if the taxpayer cannot determine such a price, nevertheless he may still establish an arm's-length price by taking the price at which similar or comparable property is sold in either the same or other market areas where the marketing conditions or quantities sold may be different. In such cases such a price can be used, but only after adjustment is made for the material differences in area, quantity, or in marketing conditions (including custom duties and transportation costs) and in any other relevant factors. Moreover, these adjustments must be determinable.

The bill provides that the Secretary or his delegate is by regulations to set forth procedures which are similar in principle to those specified above which are to be applied where one of the organizations in the group receives a sales commission, rather than actually receiving title to goods and then selling them. The bill also provides in the case of "sham" or "paper" corporations that no amount is to be allocated to a foreign corporation under this formula if its assets, personnel and office and other facilities outside of the United States are grossly inadequate to provide for its activities outside of the United States.

The bill also provides that the Secretary or his delegate may require the taxpayer to furnish information which may be "reasonably supplied" to the extent this information is needed to apply the allocation rule referred to above which makes use of assets, compensation and selling expenses. Failure to supply this information can lead to the Secretary or his delegate allocating all of the income to the United States.

The bill also provides that where, under the allocation rule set forth in this provision, income is allocated to the domestic corporation which had been subject to foreign income taxes in the hands of the foreign corporation, these foreign taxes, like other expenses related to the income reallocation, are to be attributed to the domestic corporation. Thus, if the domestic corporation is claiming a foreign tax credit, rather than taking a deduction for foreign taxes, a foreign tax credit will be available with respect to this transferred tax as well. However, the income so reallocated for purposes of the overall or per country limit is not to be classified as foreign income.

This provision is to apply with respect to taxable years beginning after December 31, 1962.

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parenthetical matter quoted in the preceding sentence would be changed to "(including a reasonable allowance for amounts expended for meals and lodging)". Under Senate amendment No. 41, such parenthetical matter would be changed to "(including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances)". The House recedes.

Amendment No. 42: Under the bill as passed by the House, the amendments made by the bill with respect to the disallowance of certain entertainment, etc., expenses were to apply with respect to taxable years ending after June 30, 1962, but only in respect of periods after such date. Under Senate amendment No. 42, the amendments are to apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date. The House recedes.

AMOUNT OF DISTRIBUTION WHERE CERTAIN FOREIGN CORPORATIONS DISTRIBUTE PROPERTY IN KIND

Amendment No. 43: Subsection (d) of section 5 of the bill as passed by the House would amend section 902(a) of the code (relating to credit for foreign taxes) to provide that for purposes of section 902 (a) and (b) the amount of any distribution in property other than money is to be determined under section 301(b)(1)(B) of the code. Under section 301(b)(1)(B) the amount of a distribution of property to a corporate shareholder is the lesser of (1) the fair market value of such property, or (2) the adjusted basis of such property (in the hands of the distributing corporation immediately before the distribution). Senate amendment No. 43 strikes out subsection (d) of section 5 of the bill. The House recedes.

AMENDMENT TO SECTION 482 OF THE INTERNAL REVENUE CODE

Amendment No. 45: Section 6 of the bill as passed by the House amended section 482 of the code (relating to allocation of income and deductions among taxpayers) by designating the existing text as subsection (a) and by adding a new subsection (b) to provide special rules for allocating taxable income, arising from sales of tangible property within a related group which includes a foreign organization, among the members of the group. The allocation was to be made by the Secretary of the Treasury or his delegate by taking into consideration that portion of the factors listed in the bill which is attributable to the United States and that portion which is not attributable to the United States. The bill also permitted consideration of other factors (including special risks, if any, of the market in which the property is sold). If the taxpayer established to the satisfaction of the Secretary or his delegate that an alternative method of allocation clearly reflects the income of each member of the group with respect to the property in question, the alternative method was required to be used.

Senate amendment No. 45 strikes out section 6 of the bill as passed by the House.

The House recedes. The conferees on the part of both the House and the Senate believe that the objectives of section 6 of the bill as passed by the House can be accomplished by amendment of the regulations under present section 482. Section 482 already contains broad authority to the Secretary of the Treasury or his delegate to allocate

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income and deductions. It it believed that the Treasury should explore the possibility of developing and promulgating regulations under this authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.

DISTRIBUTIONS OF FOREIGN PERSONAL HOLDING COMPANY INCOME

Amendment No. 46: Section 7 of the bill as passed by the House amended section 552(a) of the code to substitute a 20-percent gross income requirement for the requirement now contained in the definition of a foreign personal holding company that more than 60 percent (or 50 percent in certain cases) of its gross income consist of foreign personal holding company income. Such section 7 also amended the definition of "undistributed foreign personal holding company income" contained in section 556(a) of the code to mean taxable income (adjusted as provided by existing law) if the foreign personal holding company income exceeds 80 percent of the company's gross income, and to mean a proportionate part of such taxable income if the foreign personal holding company income does not exceed 80 percent of its gross income.

Senate amendment No. 46 strikes out section 7 of the bill as passed by the House. The House recedes.

MUTUAL SAVINGS BANKS, ETC.

Amendment No. 48: The bill as passed by both the House and the Senate amends section 593 of the code to provide rules relating to reserves for losses on loans by mutual savings institutions listed in the bill. Subsection (b)(1) of the amended section 593 prescribes the method for determining the reasonable addition for the taxable year to the reserve for bad debts under section 166(c) of the code and also specifies the reserves to which such additions are to be made. Such reasonable addition is the sum of two amounts—(1) the amount determined under section 166(c) to be the reasonable addition to the reserve for losses on nonqualifying loans, plus (2) the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans (but the amount so determined by the taxpayer is not to exceed the amount determined under pars. (2), (3), or (4) of sec. 593(b), whichever amount is the largest). Senate amendment No. 48 adds a further limitation providing that the amount of the addition for a taxable year to the reserve for losses on qualifying real property loans, when added to the amount of the addition to the reserve for losses on nonqualifying loans, shall in no case be greater than the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof attributable to the period before the first taxable year beginning after December 31, 1951). The House recedes with a substitute for the Senate amendment which provides, in effect, that the 12-percent ceiling is not to apply in the case of a taxpayer using the experience method for the taxable year.

Amendments Nos. 50 and 52: Under section 593(b)(2) of the code as amended by the bill as passed by the House, the amount of the

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(c) DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.—

(1) Section 245 (relating to dividends received from certain foreign corporations) is amended by adding at the end thereof the following new subsection:

"(b) PROPERTY DISTRIBUTIONS.—For purposes of subsection (a), the amount of any distribution of property other than money shall be the amount determined by applying section 301 (b) (1) (B)."

(2) Section 245 is amended by striking out "In the case of" and inserting in lieu thereof "(a) GENERAL RULE.—In the case of".

(d) CREDIT FOR FOREIGN TAXES.—Section 902 (a) (relating to credit for foreign taxes) is amended by adding at the end thereof the following new sentence: "For purposes of this subsection and subsection (b), the amount of any distribution in property other than money shall be the amount determined by applying section 301 (b) (1) (B)."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions made after December 31, 1962.

SEC. 6. AMENDMENT OF SECTION 482.

(a) IN GENERAL.—Section 482 (relating to allocation of income and deductions among taxpayers) is amended by adding at the end thereof the following new subsection:

"(b) SALES AND PURCHASES WITHIN A RELATED GROUP WHICH INCLUDES A FOREIGN ORGANIZATION.—

"(1) IN GENERAL.—In applying subsection (a) to sales of tangible property within a group of organizations—

"(A) owned or controlled directly or indirectly by the same interests, and

"(B) at least one of which is a domestic organization and at least one of which is a foreign organization,

the Secretary or his delegate may allocate the taxable income of the group arising from such sales in the manner set forth in paragraph (2). This subsection shall not apply with respect to any sale of tangible property for which the taxpayer can establish an arm's length price (within the meaning of paragraph (4)).

"(2) METHODS OF ALLOCATION.—

"(A) CONSIDERATION OF CERTAIN FACTORS.—Except as provided in subparagraph (B), the allocation referred to in paragraph (1) shall be made by the Secretary or his delegate by taking into consideration that portion of the following factors which is attributable to the United States and that portion thereof which is not attributable to the United States—

"(i) assets of the group, to the extent used in the production, distribution, and sale of the property,

"(ii) compensation of officers and employees, to the extent attributable to the production, distribution, and sale of the property, and

"(iii) advertising, selling, and sales promotion expenses (including technical and servicing expenses), to the extent attributable to the property.

Such method of allocation may also give consideration to other factors, including the special risks (if any) of the market in which the property is sold.

"(B) ALTERNATIVE METHODS.—If the taxpayer establishes to the satisfaction of the Secretary or his delegate that an alternative method of allocation clearly reflects the income of each member of the group with respect to the property referred to in paragraph (1), such alternative method shall be used (in lieu of the method provided in subparagraph (A)).

"(3) SPECIAL RULES.—In applying the method of allocation referred to in paragraph (2)(A), the following rules shall be applied:

"(A) ADJUSTED BASIS OF ASSETS.—The values to be assigned to the assets referred to in paragraph (2) (A) (i) is their adjusted basis in the hands of the taxpayer or, if such basis is not available in the case of a foreign organization, then their book values, adjusted to approximate their adjusted basis.

"(B) INCLUDIBLE ASSETS.—The assets referred to in paragraph (2) (A) (i) include real property and tangible personal property (whether owned or leased by a member of the group), but do not include inventory and stock in trade.

"(4) ARM'S LENGTH PRICE DEFINED.—For purposes of this subsection, the term 'arm's length price' means—

"(A) the price at which tangible property similar or comparable to the property referred to in paragraph (1) generally is or can be sold in transactions in the same areas involving unrelated persons and made under similar conditions of sale; and

"(B) if subparagraph (A) does not apply, the price at which tangible property similar or comparable to the property referred to in paragraph (1) is sold in the same or other areas under similar circumstances and in transactions involving unre

lated persons, with adjustment for material differences in quantity, marketing conditions (including customs duties and transportation costs), and other relevant factors.

Subparagraph (B) shall apply only if the adjustment referred to therein is properly determinable.

"(5) SALES COMMISSIONS.—The Secretary or his delegate shall by regulation prescribe rules for the allocation of commissions arising from sales of tangible property within a group of organizations described in paragraph (1). Such rules shall be consistent with the principles specified in the other paragraphs of this subsection.

"(6) GROSSLY INADEQUATE ASSETS, ETC., OUTSIDE UNITED STATES.—In allocating taxable income under this subsection, no amount shall be allocated to a foreign organization whose assets, personnel, and office and other facilities which are not attributable to the United States are grossly inadequate for its activities outside the United States.

"(7) INFORMATION NECESSARY FOR CONSIDERATION OF FACTORS.—In the case of any transaction to which paragraph (2) (A) applies, if—

"(A) the information submitted with respect to the group of organizations is insufficient for the

proper application of the method of allocation set forth in the first sentence of such paragraph, and

"(B) upon request of the Secretary or his delegate, such group fails to furnish such additional information with respect to such transaction as may be reasonably supplied,

the Secretary or his delegate may estimate the taxable income arising from such transaction and may allocate such taxable income among the members of the group or to any single member thereof.

"(8) TREATMENT OF FOREIGN TAXES.—

"(A) For purposes of this subsection, taxable income shall be determined without regard to any income, war profits, or excess profits taxes paid to any foreign country or to any possession of the United States.

"(B) Where the application of this subsection results in a decrease in the taxable income of any foreign organization and an increase in the taxable income of any domestic organization, then any of the taxes referred to in subparagraph (A) paid by such foreign organization and attributable to the taxable income so transferred shall be treated for purposes of this chapter—

"(i) as paid by such domestic organization, and

"(ii) as not paid by such foreign organization."

(b) CLERICAL AMENDMENT.—Section 482 is amended by striking out "In any case of two or more organizations" and inserting in lieu thereof the following:

"(a) GENERAL RULE.—In the case of two or more organizations".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1962.

SEC. 7. DISTRIBUTIONS OF FOREIGN PERSONAL HOLDING COMPANY INCOME.

(a) DEFINITION OF FOREIGN PERSONAL HOLDING COMPANY.—So much of subsection (a) of section 552 (relating to definition of foreign personal holding company) as precedes paragraph (2) is amended to read as follows:

"(a) GENERAL RULE.—For purposes of this subtitle, the term 'foreign personal holding company' for a taxable year beginning after December 31, 1962, means any foreign corporation if—

"(1) GROSS INCOME REQUIREMENT.—At least 20 percent of its gross income (as defined in section 555 (a)) for the taxable year is foreign personal holding

tax notes international

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Reprinted from 5 *Tax Notes Int'l* 399 (August 24, 1992)

: Internationally Agreed Rules or Tax Warfare?

tax policy forum

New Directions Needed for Solution of the Transfer-Pricing Tax Puzzle

by Dale W. Wickham and Charles J. Kerester

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This article is based on a paper the authors presented before the National Tax Association at a symposium on international transfer pricing held in Williamsburg, Virginia in November 1991. The substance of it also was presented to the U.S. House Committee on Ways and Means on July 21, 1992, in connection with an appearance Mr. Wickham was invited to make as a public interest witness at hearings the committee held on legislation introduced by Chairman Rostenkowski and Representative Gradison (H.R. 5270) to initiate study of proposals for major changes in U.S. taxation of international transactions.

I. Introduction and Perspective

The abstruse tax subject of international transfer pricing, commonly shrouded in mysteries fathomable, if at all, only by technical tax cognoscenti, once again is in the news, drawing the spotlight of public attention, even in popular news media. The immediate occasion for this attention is growing congressional concern that the United States may not be collecting its fair share of tax revenues from sales made in the U.S. market by businesses controlled by foreign interests and that the lost revenue may be tens of billions of dollars. Widely publicized hearings were held in April of this year,[1] as they were in July 1990,[2] by the U.S. House Ways and Means Oversight Subcommittee on the possible underpayment of U.S. income tax by foreign-controlled enterprises. The focus in these hearings on inbound sales distinguishes them from earlier congressional proceedings in 1986 on the superroyalty amendment to section 482 where the focus was on outbound transfers of intangibles developed primarily in the United States. The hearings in 1990, like those this year, were replete with sensational charges that foreign-controlled U.S. operations might have underpaid their proper share of U.S. income taxes by

[1] Unpublished Hearings Before the Subcommittee on Oversight of the House Committee on Ways & Means, 102d Cong., 2d Sess. [hereinafter, 1992 hearings], held April 9, 1992.

[2] Hearings on Tax Underpayments by U.S. Subsidiaries of Foreign Companies Before the Subcommittee on Oversight of the House Committee on Ways & Means, 101st Cong., 2d Sess. [hereinafter, 1990 hearings], held July 10 and 12, 1990 (Serial 101-123).

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reason of improper intercompany pricing by as much as the $50 billion mentioned in the 1990 hearings[3] or by the $30 billion discussed in the 1992 hearings. *Tax Notes* headlined its report on the 1990 hearings, "Ways and Means Panel Blasts Foreign Firms for Tax Dodging";[4] and even the commissioner and now Treasury's Assistant Secretary for Tax Policy Fred T. Goldberg, Jr., expressed the belief that "the U.S. government is being short-changed billions of dollars annually."[5] Members of Congress pressed Treasury and IRS spokespersons about the prospects for more vigorous prosecution of criminal and extraordinary civil penalties against transfer-pricing abuses by taxpayers.[6] Other witnesses, however, contended in the 1990 hearings that it was impossible to find abuse or to estimate revenue losses here because of the lack of definitive rules of law for determining proper transfer prices.[7] The commissioner and other IRS representatives cautioned committee members that the IRS has great difficulty winning even the basic tax deficiencies, let alone penalties, asserted in transfer-pricing cases because of the uncertainty in meaning of the current regulations' arm's-length pricing standard,[8] which was characterized by one IRS witness as existing "in a world of smoke and mirrors."[9] Nevertheless, when pressed by committee members at the 1990 hearings about whether new substantive tax rules were needed, Treasury's assistant secretary for tax policy assigned higher priority to heightened audit activity and more vigorous enforcement efforts.[10] In the hearings this year, both Treasury's Deputy Assistant Secretary and the new IRS Commissioner Shirley Peterson maintained a similar stance. They were forewarned by the subcommittee chairman, however, that they would again be called upon at public hearings next year to tell the American public whether foreign businesses exploiting the U.S. market are properly reporting their U.S. income.

The hearings were only one of several major developments this year on the subject of transfer pricing. One of the major party candidates for the U.S. presidency recently announced a revised economic plan that was headlined in the *Wall Street Journal* as calling for "Massive Tax Increases for Foreign Firms" and was reported to include as the "biggest" of several tax increases proposed to reduce the U.S. budget deficit a "huge" increase that "would fall on the U.S. subsidiaries of foreign corporations" and would "[o]ver four years . . . raise $45 billion by preventing 'tax avoidance' through a system of sheltering income known as transfer-pricing."[11] Other less publicized but important developments included promulgation of proposed regulations spelling out complex new substantive transfer-pricing rules.[12] In April Treasury and the IRS released the most recent of several congressionally mandated studies on the subject.[13] There, as in the 1988 White Paper,[14] Treasury and the IRS maintained a position similar to that taken at the congres-

[3]Statement of Oversight Subcommittee Chairman Pickle, 1990 hearings, *supra* note 2, at 62.

[4]John Turro, 48 *Tax Notes* 247 (July 16, 1990).

[5]Statement of Commissioner of Internal Revenue Fred T. Goldberg, Jr., presented July 10 at 1990 hearings, *supra* note 2, at 63.

[6]The evidence on this point in the record of the 1990 hearings is summarized and cited in Dale W. Wickham, "The New U.S. Transfer Pricing Tax Penalty: A Solution, or a Symptom of the Cause, of the International Transfer Pricing Puzzle" [hereinafter, Transfer Pricing], 18 *International Tax Journal* 1, at 17-18 (Winter 1991).

[7]*See* Wickham, "Transfer Pricing", *supra* note 6, at 17-18.

[8]*Id.*

[9]Statement of Frances Zuniga, quoted in text *infra* at notecall 40.

[10]*See* materials collected in Wickham, "Transfer Pricing," *supra* note 6 in text of that article at notecall 91 and in note 91.

[11]Jeffrey H. Birnbaum, "Clinton's Revised Economic Plan Sets Massive Tax Increases for Foreign Firms," *Wall St. J.*, June 22, 1992, at A16. The proposal as reported appears similar to section 304 of the 1992 Foreign Tax Bill, *infra* note 17.

[12]Prop. Treas. Reg. section 1.482, 57 Fed. Reg. 3571 (to be codified at 26 C.F.R. pt.1) (proposed Jan. 30, 1992).

[13]U.S. Treasury Department and Internal Revenue Service, Report on the Application and Administration of Section 482 (April 9, 1992) [hereinafter, 1992 Treasury Report]. In 1962, Congress also urged Treasury to study the possibility of accomplishing by regulation under section 482 the kind of three-factor formulary apportionment for allocating income and deductions that had been called for in the House-passed version of the Revenue Act of 1962. *See* H.R. Rep. No. 1447, 97th Cong., 2d. Sess., 537-38, accompanying section 6 of H.R. 10650, 82nd Cong., 2d. Sess. (1962).

[14]U.S. Treasury Department and Internal Revenue Service, A Study of Intercompany Pricing (Oct. 1988) [hereinafter, 1988 White Paper]. This study also was mandated by Congress in the report of the conferees accompanying the Tax Reform Act of 1986, H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986). The 1988 White Paper asserted the belief that "the arm's-length standard remains the theoretically preferable approach to income allocation," reaffirmed the commitment of Treasury and the Service to continued adherence to the basic principles of the arm's-length pricing approach used since 1968 in the Treasury regulations under section 482, and suggested for public consideration some complex methodologies for implementing arm's-length pricing for transactions involving intangible property (including a new "basic arm's-length return method"). Notwithstanding its findings about the difficulties permeating the system as a result of the lack of definitive rules, the 1988 White Paper solemnly concluded that no "safe harbors" or "simple, mechanical, bright-line tests" among the many that had been recommended should be adopted "in lieu of the fact-specific arm's-length inquiry under section 482." The stated reasons were that such safe harbors "generally would serve only to reduce tax liability," "generally result in unwarranted windfalls for taxpayers, without significant benefits for the government," and "that no one safe harbor or combination of safe harbors has yet been proposed that would be useful but not potentially abusive." No attempt is made in the 1988 White Paper to reconcile those conclusions with its findings elsewhere that the regulations fail to supply the definitive rules of law needed to enable the government to make adjustments under section 482 and to calculate whether there would be the taxpayer "windfalls" or government revenue "losses" assumed. Instead, the 1988 White

(footnote 14 continued on next page)

sional hearings,[15] but they also heralded the new advance pricing agreement ("APA") procedures implemented last year to reduce controversies.[16] Further developments this year included the introduction in Congress on May 27 by the Chairman and a high-ranking minority member of the U.S. House Committee on Ways and Means of a bill[17] that includes proposals for several major changes relevant to transfer pricing.[18]

This year's developments on transfer pricing are the latest in what has been described previously as "a crescendo of policy-level actions for the last decade by the U.S. Congress, Treasury Department, and Internal Revenue Service . . . to deal with mounting problems in the area."[19] These, we are confident, are not the last of the major new developments we will see on the subject; there are certain to be many more. The scope of the problems presented and the stakes involved for the international business community and for the major trading nations of the world are too large to permit the present level of controversy and difficulties to go unresolved.

Why are there all these developments and attention to the subject of transfer pricing? We believe that the dramatic internationalization of business over the last 30 years has rendered international tax systems outmoded and inadequate to tax income from international transactions. In other words, we believe that the present system for income taxation of international business—especially transfer pricing and inadequate sourcing rules—is a horse-and-buggy mechanism that is woefully inadequate to the demands being made on it. These demands include the escalating internationalization of business and mounting pressures within the United States to increase U.S. revenues from international business transactions.

Whenever business is transacted across boundaries of two or more jurisdictions, there is a need for determining what portion of the income (or loss) from the transaction is subject to tax by each of the jurisdictions. This is true whether the competing taxing jurisdictions are national governments or state or local governments. If the competing jurisdictions do not harmonize their tax rules, income may be overtaxed through multiple taxation or undertaxed when neither jurisdiction taxes it. The governments asserting the competing tax claims and the taxpayers who are the stakeholders of the tax on the income each have interests demanding that the governments harmonize their rules. Business taxpayers have the obvious interest of preventing or minimizing multiple taxation of income. Each government has an interest in collecting the tax revenues that otherwise may be lost through undertaxation. Government also has an interest in protecting its nationals against discriminatory or burdensome foreign taxes while seeing that foreign businesses do not gain an advantage in the domestic market by failure to pay appropriate taxes.

(footnote 14 continued)
Paper recommended, as Treasury and the Service later urged the Congress, that the Service's enforcement efforts be strengthened by enlargement of its powers to compel taxpayer production of information about transfer prices and methodologies, by more aggressive pursuit of "noncompliant taxpayers," and by making greater use of economic specialists and counsel in section 482 cases; and it pointedly invited new penalties, like ones actually enacted later, to compel taxpayer production of transfer-pricing information and to "deter overly aggressive and unjustified transfer prices."

[15] *See* the "Executive Summary and Overview" of the 1992 Treasury Report, *supra* note 13.

[16] *Id.*, Chapter 3.

[17] H.R. 5270, 102d Cong., 2nd Sess., "The Foreign Income Tax Rationalization and Simplification Act of 1992," introduced by House Ways and Means Committee Chairman Dan Rostenkowski and by Rep. Willis Gradison on May 27, 1992 [hereinafter, 1992 Foreign Tax Bill].

[18] Relevant provisions of the 1992 Foreign Tax Bill include the following:

Section 101 provides that taxpayers may take into account the interest expenses and assets of *foreign* subsidiaries for purposes of allocating and apportioning interest expenses between gross income from U.S. sources and foreign sources.

Section 201 would generally repeal deferral of U.S. tax on controlled foreign corporations by treating as subpart F income generally all of a controlled foreign corporation's earnings and profits for the taxable year.

Section 202 of the bill provides an opportunity to operate businesses through controlled foreign corporations, yet have those corporations be treated as domestic for all U.S. tax purposes including section 482. In the case of certain commonly controlled foreign corporations, domestic company treatment must be elected on a consistent, groupwide basis. In the case of other controlled foreign corporations, domestic company treatment may be elected on a company by company basis.

Section 203 provides that where the property is produced by the taxpayer and sold to a related person and the income is derived partly within and without the United States, the amount allocated to production activities under the production/marketing split can be no less than the amount that would be so allocated by applying the production/marketing split to the relevant *combined* income of the taxpayer and any related person.

Section 304 would require a minimum amount of taxable income to be reported (absent Service agreement to accept a different amount) by any 25 percent foreign-owned U.S. corporation that engages in more than a threshold level of transactions with foreign related parties. A similar rule would also apply to U.S. branches of foreign corporations. Generally, the taxpayer's taxable income from any category of business would be no less than 75 percent of the amount determined by applying the applicable profit percentage to the taxpayer's gross receipts from that business category. These rules, it should be emphasized, would not be applied to U.S. corporations or branches that are not foreign-controlled. Explanations accompanying the bill contend that this provision would not violate U.S. treaty obligations not to discriminate against business enterprises of treaty partner countries, but assert an intention that the provisions of section 304 override the U.S. treaty obligation should there be a conflict. Staff of the Joint Committee on Taxation, Explanation of H.R. 5270 (Foreign Income Tax Rationalization and Simplificatinn Act of 1992) (JCS-11-92) 48 at 55 (May 29, 1992).

[19] Wickham, "Transfer Pricing," *supra* note 6, at 1. *See* note 3 of that article for a summary of 12 legislative and administrative actions over the last decade relevant to international transfer pricing.

Within the United States, the need to harmonize competing tax claims of state and local governments has long been recognized. It has been addressed with varying degrees of effectiveness by several governmental legal structures. The U.S. Constitution includes the Commerce Clause, which enjoins any state from unduly burdening interstate commerce, and the Due Process Clause, which requires some minimal threshold of contact with a state for an interstate business transaction to be subject to its income tax. More recently the Uniform Division of Income for Tax Purposes Act (UDITPA)[20] and the Multistate Tax Compact[21] have been developed through cooperative efforts of the states to impose some uniform rules and limitations.

In the international arena, however, the United States has been slow to address the need for tax harmonization. U.S. governmental actions in the international tax arena have taken the form either of (a) unilateral enactments pertaining to U.S. income taxation of international transactions or (b) international tax agreements. International tax agreements include bilateral executive agreements (which are not treaties requiring Senate ratification) providing reciprocal restraints on each party in asserting jurisdiction to tax income from the international operation of ships or aircraft. Recently, these agreements have come to include the more significant network of bilateral tax treaties "for the prevention of double taxation and avoidance of tax."[22]

These treaties have rules that generally prescribe thresholds of minimum contacts foreign nationals must have to be subject to tax by the other country; provide exemptions or rate reductions in the tax imposed by the host country of source; provide for foreign tax credits by a country of residence for host country tax on income from sources in the host country; provide for tax authorities' information exchanges and other enforcement mechanisms; and, as we shall discuss in further detail shortly, have provisions similar to U.S. Internal Revenue Code section 482 that authorize reallocation of tax attributes among commonly controlled legal entities. Only a few treaties, however, provide more than partial rules for determining the geographic source of income from the sales of goods or services and all the items of receipt and expenditure entering into computation of taxable income from such transactions and deductions.[23] Even these few, however, do not provide satisfactory systems for resolution of conflicts that may arise from the party countries' differing interpretations and applications of those rules in specific cases. Significantly, the model treaties developed by the U.S. Treasury Department, the OECD, and the U.N. do not contain comprehensive source rules for business income from the sale of goods or services. This indicates that the U.S. Treasury Department and other countries' tax authorities have set higher priority on securing agreement on matters of less central importance.

> Only a few treaties provide more than partial rules for determining the geographic source of income. Even these few do not provide satisfactory systems for resolution of conflicts from the party countries' differing interpretations and applications of those rules.

What is transfer pricing and how do its rules work and mesh with the needs of systems for taxing international business income? The current transfer-pricing rules are the outgrowth of an approach the Treasury Department embraced in 1968 and then advocated for adoption by other countries.[24] The approach treats as an occasion for extracting an income tax any non-arm's-length transfers of goods or services among legally separate parts of an international enterprise controlled by the same interests. In other words, the approach starts by accepting as a separate taxpayer each legally separate but commonly controlled entity that happens to be used by an enterprise's managers for conduct of the business. It also starts with the allocation of revenue and expense made by the business' managers among each of the separate legal entities. For the avowed purpose of computing taxable income of each "separate" entity, the approach requires a hypothetical "price" to be con-

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[20]7A U.L.A. 331 (1957)

[21]Multistate Tax Compact, All State Tax Guide (P-H) 6310, also printed in 29 *Vand. L. Rev.* 47 *et seq.* (1976).

[22]The network of bilateral treaties of interest to a business having contacts with more than one foreign country includes not only the bilateral treaties to which the "home" country of the business is a party but also those between all foreign countries that affect income taxation of the business.

[23]*See* J. Ross MacDonald, *et al.*, 2 *Annotated Topical Guide to U.S. Income Tax Treaties* (P-H) 1463, Part C (Supp. 1990).

[24]Treas. Reg. section 1.482-1&2. For a history of the approach adopted in the regulation, see the 1988 White Paper, chapter 2. For a history of Treasury's advocacy of the transfer-pricing approach for adoption by other countries, *see* Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length," 30 *Tax Notes* 625 (Feb. 17, 1986) [hereinafter, Myth of Arm's Length].

structed for intercompany transfers. Every transfer is treated as a taxable sale, whether or not the business itself treated the transfers as sales. The hypothetical price is constructed by reference to prices at which independent parties effected transactions in comparable products, markets, and circumstances.[25] This approach permits the price to be constructed in a way that each sale creates a hypothetical profit for some members of the commonly controlled group without regard to whether the business as a whole on sales to unrelated third parties operates at a combined loss or profit.[26] The result may be that a tax nominally levied on net income may actually be levied on the gross receipts of an integrated business that operates at a combined loss.

This approach does not address issues involved in allocating income among countries of source. Rather, it focuses only on allocating revenues and costs among the legally separate but commonly controlled legal entities. Reallocation under the transfer-pricing rules from a foreign to a domestic entity or vice versa certainly may, and indeed is likely to, be effected in ways that will increase the revenues of the country requiring the reallocation to an entity taxed on the basis of the taxpayer's nationality or residence, rather than the source of the income. Furthermore, there is no requirement that power to reallocate be exercised in ways that are consistent with the principles for international division of the tax base as may be specified in source rules in the reallocating country's statute or treaties. That leaves untouched and unresolved issues as to geographic source and competing countries' claims for taxation based on source, including vital issues about the resident country's obligation to allow a reduction of its residence-based tax by a credit for foreign taxes on foreign-source income. The end result is a system strong in preserving and encouraging the power of the country to reallocate tax attributes in ways that will protect and increase its revenues but very weak and lacking in mandates to consider revenue interests and tax claims of other countries based on the source of the income. This weakness can provide a tempting opening for political leaders in revenue-hungry countries such as the United States to raise revenues through more aggressive use of the country's power to reallocate taxable income from foreign to domestic entities.

The United States and its trading partner countries need to develop and agree on rules that fix the geographical locale of the particular business activities, assets, personnel, markets, and other factors that will be treated as entitling a country to tax a portion of the income generated by the business.

Allocating or apportioning international business income (or loss) among competing jurisdictions is not just one competing view or alternative for dealing with what has come to be called the transfer-pricing problem. It is a necessity. Deciding how to do it is the problem to be solved. It is left unsolved by the present approach. We are of the view that the United States and its trading partner countries should face that problem and get to the difficult task of resolving conflict among countries about how to do it. They need to develop and agree on rules that fix the geographical locale of the particular business activities, assets, personnel, markets, and other factors that will be treated as entitling a country to tax a portion of the income generated by the business. Even if agreement is not achieved quickly, we can work to get it. It is in our interest not to expose our international businesses to double taxation or to expose our fisc to needless loss of legitimate revenues. Even while we do not have international agreement on how to do it, we should make rules that have the potential for reciprocity and international acceptance.

The conviction that formulary apportionment methods are not workable is frequently expressed by some current and former Treasury officials who advocate adherence to Treasury's arm's-length pricing regime.[27] We do not share that conviction. Apportionment is the problem to be solved. Apportionment need not be formulary; it may be, and, if so, formulas need not be arbitrary. We also think arbitrary ought not be equated to methods that are reducible to numbers required in tax returns. We certainly think the apportionment methods used should be reducible to numbers required on tax returns. Aiding preparation of the tax calculations needed for tax returns and for payment of the tax thought to be due is the purpose for which

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[25] Treas. Reg. section 1.482-1(b).

[26] Treas. Reg. section 1.482-1(d)(4). For a further discussion of this aspect of the Treasury's arm's-length pricing rule, *see* Wickham, "Transfer Pricing," *supra* note 6 at 12, especially in the text at notecall 65 in that article; and Langbein, "Myth of Arm's Length," *supra* note 24, at 638 and 646.

[27] *See*, for example, the remarks attributed to former Assistant Treasury Secretary Gideon made April 27, 1992 in New York City in 1 *Tax Management Transfer Pricing Report* 5 at 6 (May 13, 1992); *see also* the remarks of Lowell Dworin, Director of Treasury's Office of Tax Analysis, made in April 1991 in Arlington, Va before the National Tax Association.

any apportionment method is adopted. We do not share any conviction that there are no such methods, or that such methods are undesirable. Avoidance of specificity for the sake of flexibility produces the very vagueness or lack of rules which is a root cause of the morass growing out of the current case-by-case approach. Empirical evidence about various apportionment methods, including some formulary apportionment methods, does not justify a conclusion that they are all unworkable, and certainly not the conclusion that Treasury's arm's-length pricing method is superior to all direct apportionment methods. Such conclusions can blind one to serious examination of alternatives for getting out of the current morass. Apportionment presents many, many difficulties, but it is the task to be accomplished and its difficulties will not go away because they are hidden behind a nonformulary approach that does not operate by reference to factors reflecting the geographical locale of the business activities, assets, personnel, markets, and other inputs which are the bases on which countries claim a right to tax a portion of any income generated by these activities. A formulary method of apportionment is not a necessity, but does offer a solution of conflicts among competing multinational taxing jurisdictions. Some formulary methods of apportionment are certainly less arbitrary and more promising than the all-or-nothing approach used by the United States in exercise of its section 482 powers to reallocate taxable income to U.S. domiciliary entities that operate without regard to source rules or to the all-or-nothing approach of the United States in its title-passage rule for sourcing income from sales of goods.

We, accordingly, think that public attention to the abstruse tax issues surrounding transfer pricing is healthy and warranted by the very high stakes associated with the disposition to be made by the international community of the problems growing out of this aspect of multinational systems for taxation of income from international sales of goods or services. We believe the developments giving rise to this attention reflect a set of related problems that should rank very high on any list of tax policy issues for attention by officials in the governments of the United States and its trading partners. These developments reflect problems having cures that can be diagnosed and treated more successfully if we put aside the biases associated with the outmoded system of transfer pricing and focus on more carefully defining and then meeting problems under the present system through more promising lines of approach.

II. Problems Under the Present System

Our analysis indicates that a few core problems are not only at the root of present difficulties but also are the cause of additional, derivative problems that can be remedied only if the steps are taken to remedy the core problems. We will first identify the core problems we see, briefly discuss their causes, and then discuss some of the additional problems that derive from the core problems, again identifying their causes so that appropriate solutions can be identified. Solutions for some are not solutions for others. There is no single or simple solution.

We note at the outset that all of the core problems under the present systems are caused by failures of government, not by taxpayer abuse or evasion as is so commonly asserted or assumed in discussions of the subject. This means that remedy of these problems can be effected only through governmental actions in those areas.

A. The Core Problems

1. The Lack of Rules

One central problem permeating the entire area is a lack of clear, definitive rules that are both informative about what is expected and reducible to numbers required on tax returns. The rules lacking are of three distinct but related kinds: (1) workable rules for determining transfer prices; (2) rules for geographic allocation of income or loss from international business transactions; and (3) rules for meshing the first two sets of rules so that they will work together as integrated parts of a single tax system to prevent over-taxation or under-taxation. We discuss each of these further below.

This lack of rules for determining transfer prices is "accepted as fact and described at length" by Treasury and the IRS in the White Paper.[28] This deficiency seems not to be so clearly understood, however, by some members of Congress. The questions they asked at the 1990 and 1992 oversight hearings led senior Treasury and IRS officials to caution about the difficulties encountered in establishing transfer prices. Further, the lack of rules for geographically sourcing international business income among various taxing countries and for meshing their operation with that of the transfer-pricing rules seems not to be so clearly understood, either at Treasury or in Congress. This is evidenced by remarks of some senior congressional, Treasury, and IRS officials at the 1990 and 1992 hearings that incorrectly assume that there are rules one might use for determining whether the United States is getting its fair share of tax from international business transactions.

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[28]Wickham, "Transfer Pricing," *supra* note 6, at 11.

a. Government failure

The lack of rules is caused not by taxpayer abuse or evasion, but by failures of government.[29] In the United States, Congress has failed to enact statutes that resolve questions in specific cases. Rather, this power has been delegated to Treasury and the IRS. They have failed to exercise this delegated power in a way that permits easy application to specific cases. This failure is followed by another. Neither in litigation nor in administrative procedures has the IRS stated the principles supporting particular deficiencies. In this connection, Chief Judge Nims of the U.S. Tax Court recently remarked that, "getting an agreed statement of the issues is the single most difficult and most significant part of the job of a trial judge in a large section 482 case," due in significant part to an unwillingness on the part of the IRS to be pinned down to a theory.[30] Foreign governments also generally have failed to prescribe rules that resolve specific cases. On the part of both the United States and foreign governments, there is a failure to arrive at principled agreements regarding the rules of law that are to be used, whether in competent authority, arbitration proceedings, or elsewhere, for resolving conflicts among countries' differing laws as applied in specific cases.[31]

b. Policy choice

The lack of clear rules is a policy choice. In the United States, this failure is the result of conscious, deliberate— and reversible— decisionmaking. Congress delegated responsibility to Treasury and the IRS, and left the responsibility there despite strong evidence that their regulations do not work. Treasury and the IRS have deliberately rejected "bright-line" rules or "safe harbors" in favor of disposition on a case-by-case basis with reference to "all the facts and circumstances" of each case.[32] Treasury and IRS policymakers thus reserve decision about what rule is acceptable in a particular case. They wait until the taxpayer's return has been filed and even, in many cases, until after controversy over what is acceptable has reached trial. The Tax Court's comments about the IRS shifting positions in *Sundstrand*[33] and other recent cases dramatically spotlight this problem.

The failure of government to publish substantive rules of tax law that are reducible to numbers required on tax returns defeats the U.S. system for voluntary self-assessment and necessitates an enormously costly case-by-case, after-the-fact approach.

c. Effect on compliance

Successful functioning of the U.S. system for the self-assessment of the income tax requires that taxpayers be clearly informed in advance of behavior expected in computing tax shown as due on their tax returns. The failure of government to publish substantive rules of tax law that are reducible to numbers required on tax returns defeats the U.S. system for voluntary self-assessment and necessitates an enormously costly case-by-case, after-the-fact approach. The Treasury and the IRS have followed this route, however, for at least a quarter of a century. This approach generates other ill effects which pervade the system at all levels. They are discussed further below.

Vague rules accomplish little, except to invite litigation. Vague rules are double-edged. They permit each party to interpret them in a fashion most favorable to that party, whether it is a taxpayer, the IRS, or the tax authorities of another country.

This problem is continued, not remedied by the newly proposed regulations and by the advance pricing agreements with individual taxpayers. The proposed regulations rely on after-the-fact analysis; they do not provide rules of law that would enable a conscientious taxpayer to know in advance what is expected. They also rely not only on data obtained from others, but about future years as well. A taxpayer must now also be clairvoyant. The advance pricing agreements also operate taxpayer-by-taxpayer, case-by-case.

2. Hypothetical Prices

A second major core problem is the requirement of Treasury regulations that hypothetical, arm's-length "prices" be constructed for non-arm's-length intercompany transfers for which there are no real prices set in the marketplace. Super-

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[29] *Id.* at 28.
[30] *Id.* in note 121 at 44.
[31] *Id.* at 28.
[32] *Id.* at 29. For further evidence of the Treasury and Service stance in this regard, *see* the extracts from the 1988 White Paper quoted *supra* at note 14. Just as the White Paper reflected antagonism by Treasury and the Service to any safe harbors, the proposed regulations issued in January 1992 provide no safe harbors, although Treasury and the IRS this time invited comments with respect to certain possible safe harbors.

If a transfer does not clearly qualify under any of the first three methods of the existing regulations, a taxpayer filing its return for the year in which it made transfers of property to a controlled party thus can have no confidence that the price at which it actually charged the controlled party for the goods will satisfy the regulations.

The responsibility for the absence of more definitive guidance for such a taxpayer must be placed squarely on the lack or more definitive guidance from Treasury and the Service.

[33] *Sundstrand Corp. v. Commissioner*, 96 T.C. 226 (1991).

ficially, this problem is different from the first core problem having to do with a lack of rules, since here at least there is an explicitly stated rule in the Treasury regulation. This superficial difference, however, often turns out not to be real in practice because of the pervasive lack of comparables, a lack of rules for determining what is comparable, and the lack of rules for setting transfer price in the absence of comparables, discussed further below. Nevertheless, this core problem is in fact quite different from the general lack of rules. That is because here there is a quite explicit regulatory rule, heavily sanctioned by an array of penalties for its violation,[34] which compels taxpayers, tax collectors, and the courts all to cope with the massive, costly, and often futile search for third-party comparables that is compelled by the rule, as we develop further below. The rule requiring the search for comparables also presents major difficulties, beyond money and time costs, that are peculiar to this particular rule.

Another aspect of this core problem that distinguishes it in one very important respect from some of the others is that it can be quickly remedied by unilateral administrative action on the part of Treasury and the Service. The regulation could be amended in any one of several possible ways we shall mention shortly.

a. The wrong question.

The current Treasury regulation focuses attention on the wrong question: It asks, "What price is right for intercompany transfers?" The right question is "What portion of the combined profit or loss derived by all participating units of an enterprise from an international transaction should be geographically sourced to each of the countries claiming jurisdiction to tax part of that income?" Allocating or apportioning taxable income among countries is the task to be accomplished; that is quite different from allocating or apportioning taxable income among internal units of a business enterprise.

Price and profit obviously also are not the same; they are very different and ought not to be confused with one another. Constructing a hypothetical price for intercompany transfers of property is very different from determining and geographically allocating the group's profit or loss from arm's-length market transactions with uncontrolled parties. Yet, it is the latter and not the former that determines the income tax payable to each of the countries asserting jurisdiction to tax income. Nevertheless, current Treasury regulations make liability for tax turn on hypothetical prices for transactions that are essentially acts of self-dealing for which there are no real prices set by market forces. The newly proposed regulations would perpetuate this approach unless they are modified before promulgation to permit use of other methods as we recommend.

b. The wrong approach.

Other articles have commented at length on the enormous practical and conceptual differences presented by the arm's-length pricing requirement of the Treasury regulations.[35] Here, we shall limit ourselves to some key evidence presented in Treasury's 1988 White Paper and 1992 Report and at the public hearings held in 1990 by the House Oversight Subcommittee.

The White Paper concluded that "the section 482 regulations rely heavily on finding comparable transactions," that "they provide little guidance for determining transfer prices in the absence of comparables," that "comparables are often difficult to locate, and may be misused or misinterpreted even if they are found," that in "most of the cases . . . [studied], no comparables were available," and that—

One of the most consistent criticisms of the section 482 regulations is that they do not provide taxpayers with enough certainty to establish intercompany prices that will satisfy the Service without overpaying taxes. Based on the government's experience in litigation, the current section 482 regulations also fail to provide the Service and the courts with sufficiently precise rules to make appropriate section 482 adjustments, especially when third-party comparables are not available.[36]

Even the 1992 Treasury Report concedes that "the development of a transfer-pricing case requires extensive resources compared to the resources needed for most other cases."[37] It acknowledged that "[t]he IRS must identify all of the related entities and the nature of their interrelationships and then must compare the entities under review with unrelated entities that may be similar," that "[t]he IRS also must assemble and evaluate economic data and make complex decisions about the values of activities, assets, and risk," and that "[t]ransfer pricing examinations require experienced personnel and the participation of specially trained international examiners ("IEs"), attorneys, economists, and outside experts."[38] The same report continues with observations about third-party information to the effect that the arm's-length standard makes

[34]For a summary and discussion of these penalties, *see* Wickham, "Transfer Pricing," *supra* note 6, at 3-7, 15-18, and 23-24.

[35]Wickham, "Transfer Pricing," *supra* note 6, at 10-19; Langbein, Myth of Arm's Length, *supra* note 24, passim.

[36]1992 White Paper, *supra* note 14, at S-12

[37]1992 Treasury Report, *supra* note 13, at 1-4.

[38]1992 Treasury Report, *supra* note 13 at 1-4.

data from third parties unrelated to the taxpayer "highly relevant" and that such information is "most useful" when it is specific, extensive, and relevant."[39]

Particularly revealing testimony was presented to the House Oversight Subcommittee at the 1990 hearings. Frances Zuniga, a former IRS international examiner in Los Angeles stated that, "[a]t the heart of the problem is section 482 and the regulations. No one knows what arm's-length means. This is especially true because there are simply no comparable transactions for many of these companies. The arm's-length standard exists in a world of smoke and mirrors. The arm's-length standard pretends that related companies behave as if they are unrelated, and assumes that in each marketplace there are willing buyers and sellers. This assumption clearly does not work where the market is controlled." To determine a price where none of the first three pricing methods can be used, she said the IRS must rely on "the fourth method," which is "any reasonable" method. Despite the growing dependence on it, Zuniga observed that the regulations give almost no guidance about it. Instead of providing flexibility to the IRS, she thought the result "becomes chaotic, again because no one knows or can agree on what exactly is an arm's-length standard." Zuniga testified that the results are predictable. The taxpayer and its attorneys take one extreme position; the IRS the other. She noted that resolving this difference is a costly process for both sides. This, in her judgment, "guarantees a tax policy that is inconsistent, lacks integrity, and does nothing to motivate voluntary compliance." It also lowers morale at the IRS. She said, "One of the reasons I decided to leave the IRS was because of my dilemma with this situation. I believe in the tax system. I understand that tax law is not always 'fair' to all taxpayers all the time. But, tax laws need to be administered evenly and consistently all the time, and I am not sure this happens with the administration of section 482."[40]

Further indications from experienced tax professionals about difficulties with the arm's-length pricing standard appear in a letter submitted for the record of the 1990 Hearings of the House Subcommittee by Chairman John James of the Multistate Tax Commission ("MTC"). After expressing concerns of the commission and member states about underreporting of tax to the IRS by foreign-controlled business, Chairman James stated that although "Treasury committed to involve the states in a reexamination of the efficacy of the transfer-pricing approach," its reexamination seems to have been based on the premise that the arm's-length approach is the only solution. "Treasury," he said, "assumed only tinkering and minor adjustments rather than a reconsideration of an unadministrable method, were required. . . ." He reported that the MTC believes the problems with section 482 are due in large part to the inherent problems with the arm's-length method. He noted that the states, based on approximately 75 years' experience with determining taxable income of multistate and multinational businesses, came to rely on a formulary apportionment approach as the most accurate method to determine taxable income. He observed that the arm's-length method has problems because it (1) is administratively complex to audit millions of transactions; (2) is not an internationally accepted standard since, while most industrial nations have signed tax treaties committing themselves to the arm's-length theory, the rules and level of implementation are not uniform; and (3) does not accurately reflect the manner in which multinational enterprises operate and earn their income. Chairman James expressed the view of the MTC that separate accounting had been criticized by Congress' General Accounting Office and others for failing to provide consistent, equitable measures of income; that separate accounting works when activities are in fact separate, but not when they are integrated; that with the changes in the European markets due to implementation of EC 1992 and the dramatic changes in the Eastern Bloc countries, there will be even more integration, not less; and that calculating taxable income via separate accounting methods will become more artificial and complex in the years ahead. He said that U.S. tax experts, in response to concerns about complexity, earlier this year recommended that the European Community look at formulary apportionment as an alternative because it ". . .involves much greater administrative ease for taxpayers and administrations alike." James noted that under the arm's-length approach, every transaction between related corporations has to

> The arm's-length standard exists in a world of smoke and mirrors. The result becomes chaotic. The taxpayer takes one extreme position; the IRS the other. This is a costly process.

[39] *Id.* at 1-4.

[40] 1990 hearings, *supra* note 2, at 142 and 143.

be examined. Often, however, there is simply no evidence of what an arm's-length price for a product or service might have been. Finally, despite the need for an exhaustive examination of many transactions, the IRS often must rely on guesstimates to determine the arm's-length prices.[41]

At the 1990 Hearings, Commissioner and now Assistant Treasury Secretary Goldberg informed the subcommittee that —

> I ought to point out, as you have heard publicly and in executive session, these are extremely difficult cases to make. There are cases where our pricing turns out to be as wrong as the taxpayer's pricing. If we say it is $10 and they say $20 and the court comes in at $15, we are half wrong.[42]

c. A simpler approach.

One can readily agree with a declaration made by Treasury policymakers in the regulation promulgated in 1968 under section 482 as follows:

> The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers.[43]

One corollary to the above quotation would have been for Treasury to simply disregard non-arm's-length transactions between members of a controlled group, just as intercompany transactions are disregarded in consolidated returns, and just as transactions among commonly controlled or related parties are disregarded for many other tax purposes. That could logically follow from the assumed complete power of controlling interests to control the affairs of each member and could be justified on grounds that non-arm's-length transactions are essentially acts of self-dealing.

Treasury policymakers who framed the regulation promulgated in 1968, however, made a contrary decision. Instead, they gave presumptive respect to non-arm's-length transactions between related members of a controlled group but reserved the right for the IRS, after the fact, to question transactions on audit. In making this examination the IRS applies the standard of hypothetical sales with discretion limited only by the constraint that the IRS must not be arbitrary, capricious, or unreasonable, and with the burden of proof resting on the taxpayer. The proposed regulations continue this approach.

> Treasury could simply disregard non-arm's-length transactions between members of a controlled group, just as intercompany transactions are disregarded in consolidated returns, and just as transactions among commonly controlled or related parties are disregarded for many other tax purposes.

Enormous compliance and enforcement costs were generated by this decision. Deprived of the opportunity to use, for tax purposes, only actual arm's-length sales to customers or purchases from suppliers for which there are actual market prices, taxpayers and tax collectors are compelled to construct or create a hypothetical price for all the economic activities connected with every internal transfer. We suggest that the same administrative authority used to adopt this costly rule in 1968 be used again by Treasury to reverse the earlier error.

d. Transfer pricing not necessary.

The statutory provisions of section 482 do not require the arm's-length pricing required by the existing Treasury regulations.[44] Nor

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[41] 1990 hearings, *supra* note 2, at 442-45.

[42] *Id.* at 169. The difficulties of the arm's-length pricing requirement were also recognized by the Staff of the Joint Committee on Taxation in its explanation of the provisions of the recently introduced 1992 Foreign Tax Bill, *supra* note 17. The explanation states:

Under existing regulations, the Service attempts to apply section 482 by application of a so-called "arm's-length" standard. That is, the Service attempts to reallocate income by simulating the transactions that the commonly controlled parties would have entered into had they not been commonly controlled. This may require access to significant amounts of information from each of the related parties to a transaction, or analysis of transactions between other parties that might be considered comparable to the transactions between the related parties. In a multinational context it may be especially difficult for the IRS to obtain the desired information from foreign members of the multinational enterprise. Various statutory and other procedural rules are intended to bolster the ability of the IRS to obtain this information. It may also be difficult to obtain adequate information about comparable or near-comparable transactions involving unrelated persons. Such information may be proprietary to the parties involved (who may not include the taxpayer), and, even if the IRS could use its powers to obtain such information, disclosing it to the taxpayer may constitute a breach of confidentiality laws. Staff of the Joint Committee on Taxation, Explanation of H.R. 5270 (Foreign Income Tax Rationalization and Simplification Act of 1992) (JCS-11-92) 48 at 49 (May 29, 1992).

[43] Treas. Reg. section 1.482-1(b)(1).

[44] Prior to their issuance in 1968, the predecessor regulations since 1934 did not require an arm's-length price. They did require an arm's-length standard, but not an arm's-length price. Article 45-1 of Treas. Reg. section 86. An arm's-length standard does not require an arm's-length price. The latter is the requirement imposed by the Service and Treasury, first in proposed regulations under section 482 in 1966 and then in final regulations adopted in 1968. The provisions of section 482 or provisions corresponding to it in earlier years were in place since at least the 1928 Act. The earliest version originated in the Treasury regulations in 1917. Treas. Reg. section 41, Articles 77 and 78. The regulations were codified by section 1331 of the Revenue Act of 1921.

does any provision of any tax treaty in force to which the United States is a party. Article 9 of the Treasury Department's 1981 model treaty, which is illustrative of provisions in the various treaties in force, does not require transfer pricing.[45]

An argument that treaties require an arm's-length price is not supportable. While we acknowledge that the proper standard is that related parties must deal with each other as independent parties would, that standard does not require an arm's-length price. An arm's-length price is only one means of satisfying an arm's-length standard. It is not the only means. Many unrelated parties enter into joint ventures with each other under which the combined taxable income (or loss) from the joint venture's activities with unrelated third parties must be allocated between the members of the joint venture. That rationale was recognized by the IRS in the White Paper. That interpretation of the statute is not restricted to requiring an arm's-length price is borne out by the fact that the former regulations, prior to the adoption of the existing regulations, in 1968, required an arm's-length standard but did not expressly require an arm's-length price. Moreover, the profit-split method applied by the IRS on audit or by the courts in litigation as the "fourth method" is not regarded as breaching treaty provisions that require use of the arm's-length standard. Similarly, the profit-split method suggested by the White Paper was regarded by Treasury as satisfying such treaty provisions, and for the same reason.

e. The international norm?

A key argument in Treasury's defense of the arm's-length pricing requirement is that arm's-length pricing is the international norm. That contention was seriously challenged by Stanley Langbein in 1986 on the basis of extensive research into other countries' laws and practices.[46] It also was challenged by Multistate Tax Commission Chairman John James in his letter to the House Oversight Subcommittee at the 1990 hearing.[47]

Even so, Treasury recently affirmed its adherence to this course. In the 1992 Treasury Report, Treasury said:

> The standard that the IRS applies in a transfer-pricing case is the internationally accepted "arm's-length standard." The correct transfer price is the price that would be charged in an identical transaction between unrelated parties dealing at arm's-length. The arm's-length standard is incorporated into all U.S. income tax treaties (as well as almost all other income tax treaties). In addition, the arm's-length standard has been explicitly endorsed by international organizations such as the OECD and the United Nations. Every major industrial nation accepts the arm's- length standard as its frame of reference in transfer-pricing cases.[48]

This quotation is erroneous in two important respects. First, it erroneously equates the "internationally accepted arm's-length standard" with the "standard that the IRS applies in a transfer-pricing case." Second, by referring in the singular to "the" arm's-length method, the quoted passage blurs the plurality of methods actually used and recognized under the arm's-length standard. It also obscures the fact that several of those methods do not mandate the transfer-pricing method. We doubt that careful lawyers, even Treasury's, would argue that all other methods are precluded.

If research were to show that the laws and practices of major industrial nations permit methods other than transfer pricing, the international norm could no longer be cited by Treasury as a bar to changing its regulation to permit use of less costly and more satisfactory methods. If, on the other hand, research were to show that the laws and practices of "every major industrial nation" actually preclude use of any method other than transfer pricing, Treasury would be well-advised to take the lead in securing acceptance of more workable methods. We would hope that Treasury recognition of the enormous costs of the present transfer-pricing rule and of the availability of several other recognized methods for implementing an arm's-length standard would be sufficient for it to take a lead in efforts to implement more satisfactory alternatives.

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[45] Article 9 of the Treasury Department's 1981 model treaty provides as follows:

1. Where

(a) enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises. but by reasons of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

[46] Langbein, "Myth of Arm's Length," *supra* note 24. So far as we are aware, the Treasury Department has never responded, other than in highly conclusory terms to the various points and evidence presented by Professor Langbein. A factual response on a country-by-country basis to each of the points and evidence of Professor Langbein could be quite useful.

[47] *See* letter of John James quoted in text *supra* at notecall 41.

[48] 1992 Treasury Report, *supra* note 13 at 1-3&4. The contention is made even more emphatically in the 1988 White Paper in chapter 7B, *supra* note 14, at S-14. There it is concluded that "This overwhelming evidence indicates that there in fact is an international norm for making transfer pricing adjustments and the norm is the arm's-length standard."

3. Taxation of Branches Compared

A third core problem we see is the use by the United States of one set of rules for taxing international businesses conducted through subsidiaries or other affiliated corporations and an entirely different set of rules for taxing international businesses carried on through unincorporated branches or directly without even a branch. This is recognized in examples presented by the staff of the Joint Committee on Taxation with respect to section 203 of the 1992 Foreign Tax Bill.[49] The newly proposed regulations would make no change to this approach.

U.S. law does not require powers under section 482 to be exercised with regard to rules for determining the source of income that are in the U.S. statute or U.S. tax treaties. The United States thus may increase the taxable income of a U.S. corporation in a group by reallocating to it income that U.S.-source rules may treat as being from foreign sources. In addition, powers under section 482 may be exercised so that income derived by a business using incorporated affiliates is taxed quite differently from the way that the same income would be taxed if it were derived by a business enterprise that operates through branches of the same corporation.

The difference in tax resulting from this lack of coordination between U.S.-source rules and U.S. rules under section 482 has not been justified as a policy matter so far as we are aware. The resulting complexity and unjustified differences in tax treatment could be unilaterally remedied by administrative or legislative action.

4. Lack of International Agreement on Rules

A fourth core problem in the area is the lack of international agreement on (1) substantive sourcing rules for the division of profit and loss, (2) procedural rules for resolving conflicting multinational interpretations of such rules as they relate both to assertion of a nation's jurisdiction to tax by reference to source and its allowance of a foreign tax credit, and on (3) rules for coordinating or meshing application of source rules with the exercise of section 482-type powers.

We have commented earlier on (1) the lack of source rules in model tax treaties, (2) the lack of source rules in tax treaties in force, and (3) the lack of coordination of source rules and section 482-type rules. We will discuss later in the article remedial actions that may be taken to deal with these problems.

> The complexity and unjustified differences in tax treatment resulting from the lack of coordination between U.S.-source rules and U.S. rules under section 482 could be unilaterally remedied by administrative or legislative action.

Here we limit our comment to identifying these as major problems and to observing that the kinds of issues that must be addressed to arrive at workable source rules for geographically allocating the income tax base appear to be ones that can supply the more specific standards needed to reduce vagueness of the rules for the exercise of the section 482-type powers and to coordinate those with the source rules.

B. Derivative Problems

Several other problems under the present system are consequences of the core problems just described. Here, we will identify some of these derivative problems and note their causes and possible cures.

1. Overburdening of Resolution Systems

The U.S. system for resolution of tax controversies and the meager international structures provided under bilateral tax treaties for competent authority proceedings are overburdened by the present system. This is due partly to the absence or vagueness of rules and partly to the U.S. Treasury regulations' requirement for use of arm's-length pricing. This is due also to the absence from all countries' proceedings of at least one of the three or more real parties in interest there are in international income tax cases and to a lack of power on the part of anyone to compel interpleader of the missing parties in interest. Thus, foreign tax authorities are absent from proceedings in the U.S. Tax Court or other courts, the IRS is absent from foreign countries' tax proceedings, taxpayers are absent from competent authority proceedings—and neither the taxpayers nor any of the countries party to a tax dispute can interplead the other.

Chief Judge Arthur Nims of the U.S. Tax Court recently reported that the dollar amount of tax in controversy in section 482 cases docketed in the Court was $32 billion, which is twice the amount in conflict just two or three years ago.[50] That figure does not include substantial additional amounts being

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[49] *See* Staff of Joint Committee on Taxation, Explanation of H.R. 5270, *supra* note 18 at 34 and 35.

[50] 92 *Tax Notes Today* 68-4 (March 30, 1992).

contested in cases still in the administrative process.

2. Uncertainty of Government Revenues

The lack or vagueness of the different kinds of rules previously noted prevents governments from making reasonably accurate estimates of income tax revenues they may expect from international business transactions.[51] This applies to forecasts of income tax revenues a government can expect from (a) exercising its power under section 482 (or a foreign equivalent) and (b) from discharging its statutory or treaty obligations under the foreign tax credit to cede some of these revenues to foreign countries of source.

The resulting inability of government to predict with reasonable accuracy the revenues it may expect to derive and keep from international business transactions has multibillion dollar budgetary implications for the United States. Overestimation of revenues from international business transactions leads to underestimation of revenues needed from other sources. Underestimation of revenues leads to overestimation of revenues needed from other sources. These budgetary implications will only grow larger as the level of international business activity increases or as the measure of vagueness of the rules increases.

3. Inability To Determine Fair Share

The inability of a government under the present system to answer the question whether its country is getting its fair share of revenues from income taxation of international business transactions is separate and distinct from the inability of a government to forecast the absolute amount of revenue it may expect to receive from such transactions. Both inabilities are due to the lack or vagueness of rules, but uncertainties about fairness stem from a lack of different kinds of rules, have a more powerful political potential for generating trouble, and require different kinds of action to remedy the difficulty.

The issue of fairness has a potential for causing major difficulties in international relations. These difficulties may take the destructive form of multinational tax warfare, in which one country's punitive or discriminatory taxation of foreign-controlled businesses provokes retaliatory taxation. More than the absolute level of tax revenue is involved. Widely and deeply held concepts of political and economic justice, equity, and fair play are also involved. Americans may see the issue, for example, in terms of whether foreign-controlled businesses exploiting the U.S. market are paying taxes commensurate to their U.S. income and comparable burdens of Americans. This view may translate into political pressures on elected officials to raise revenue from the politically "low-cost" source of foreigners who do not vote in U.S. elections.

Our political leaders would be well-advised, however, to remember that an increase in the taxation of those without representation may be mirrored in foreign countries where U.S.-controlled firms do business. The same officials who are pressed by their citizenry to tax foreigners may also find themselves pressed by their U.S.-controlled business firms to advocate the latter's interests for fair and nondiscriminatory tax treatment by foreign governments.[52]

Answering the question whether a country is getting its fair share of revenues from income taxation of international business transactions requires more than unilateral actions on the part of each country competing for a share of that revenue. Each competing country may unilaterally make and enforce its own rules as to the amount of tax it will seek from an international business, on grounds either that the business is locally domiciled or that the geographic source of the income is local. The tax determined under those unilateral rules is, however, only a declaration of that country's position. Foreign countries may or may not consider that to be a fair share. Fairness of national shares of revenue from multinational income taxation of business transactions can be settled only by reference to agreed rules or by judicial or other arbitrators whose decisions are accepted and respected by the relevant countries.

The fact is that such internationally agreed rules are generally lacking. U.S. tax rules for exercising its power under section 482 are not rules for geographically sourcing such income among competing countries. Source rules used by the United States are separate from and are not coordinated with rules for its exercise of section 482 powers, which generally are applied unilaterally and frequently without regard to positions on sourcing taken by the United States itself, let alone by other countries.

Given these facts, we submit that discussion by U.S. tax officials of the question whether the United States is getting its fair share of tax revenues from taxation of international business would be more productive if it did not proceed on the false premise that rules exist for determining what is fair.

Pursuit of public discussion on the correct premise that the needed rules do not exist could be produc-

[51] *See* text *supra* in paragraph preceding notecall 28, at II. A. 1.

[52] Responsive to such concerns, Congress long ago enacted provisions of U.S. income tax law which authorize the president to institute retaliatory taxation of foreign nationals of countries found by the president to have imposed taxes which are "more burdensome" or "discriminatory" against U.S. nationals. *See* IRC sections 896 and 891.

tive. Thus, it could be productive for Congress and Treasury to discuss whether they are willing to have U.S.-controlled businesses subjected to tax by foreign countries under the source rules used or sought by the United States. For example, if the United States wants the fairness of the U.S. share of income tax on foreign controlled businesses on inbound sales of goods into the U.S. market to be determined by reference to U.S. destination of the sales as a factor, is it willing to accept a foreign country's use of the same destination-of-sale factor in a source rule for taxing outbound sales of goods manufactured primarily in the United States, especially where they are produced under patents or processes developed primarily in the United States? Similarly, if the United States wants fairness of its share of tax from inbound sales of services rendered abroad but for consumption in the U.S. market to be determined partly by reference to their U.S. destination, is it willing to make corresponding changes in its present source rule that places compensation for services wholly in the country where the services are rendered? These and many, many similar questions are really involved in the high-stakes issues under discussion. Our answers to many of these questions may not come easily, for the issues frequently are complex and they do carry high revenue stakes. Answers are likely to be found if U.S. government tax officials acknowledge that issues of geographical allocation of the income tax base are what are involved, address them candidly, and then seek the views of trading partners on these issues.

The past and current focus on intercompany transfer prices reminds us of the story of a man who explained to an inquiring passerby that he was looking under the street light for a coin he said he had lost in a dark place down the street because there was more light where he was searching. The lost coin could be found only if the search were moved to the dark place where it was lost and more light were brought to bear to aid in the search. The search and the searchlight for finding fair national shares of revenues from multinational taxation of international business transactions must be focused on questions of how resulting income (or loss) should be geographically allocated among countries competing for shares of the pie, not on questions of how to exercise section 482-type powers without regard to internationally agreed rules of source.

> There is a need for all responsible agencies of government, both in the United States and abroad, to work constructively and cooperatively to supply the framework needed for taxing international business transactions. That course offers a promise of international tax harmony rather than international tax warfare.

We believe that the question whether a country is getting its fair share of income tax revenues from international transactions is highly appropriate and deserving of an answer, not only by the United States but also by all countries seeking to tax income from international business transactions. We thus believe that the U.S. House Ways & Means Oversight Subcommittee Chairman and supporting members have been quite right in challenging our tax officials to tell the American public whether the United States is getting its fair share. This challenge is fair; it assigns responsibility to Executive Branch officials who, in accord with requested congressional delegation, have pursued a case-by-case, after-the-fact approach that generally ignores sourcing rules while also generating other enormous problems.

Congress must shoulder its share of responsibility. For 30 years it has acquiesced to the Executive Branch. Thirty years of mandating new studies is evidence it knew that the Executive Branch approach was missing the main issue and not working.

If all that were involved were the fixing of blame, there would be more than enough blame for all branches of government. There is much more involved, however. There is a need for all responsible agencies of government, both in the United States and abroad, to work constructively and cooperatively to supply the framework needed for taxing international business transactions. That course offers a promise of international tax harmony rather than international tax warfare.

4. The Potential for Overtaxation

The present system generates a potential for overtaxation of international business, with the consequent depressing effect that it may have on the level that would occur if only proper taxation were allowed.

5. Undertaxation of International Business Transactions

The potential of the present system for undertaxation was the focus of both the 1990 and the 1992 hearings of the House Oversight Subcommittee. This potential is clearly recognized by U.S. policymakers, as is the possibility that billions of dollars may be in-

volved. Not so clearly recognized is the fact that clear rules for determining each country's proper share of taxes do not exist. We again submit that public discussion of this possibility would be more constructive if it proceeded on the premise that the needed rules are lacking. Government efforts could be channeled into developing the needed rules instead of being expended on finding taxpayers who are abusing or evading rules which in fact do not exist.

The present search for evaders of rules that are erroneously assumed to exist may produce ironic results. It may miss substantial underpayments that result not from evasion of rules but from defensive measures naturally adopted by international business firms to protect themselves against the extensive and costly controversies which are likely to arise precisely because of the absence of guidance necessary to prepare tax returns. For example, a conscientious, law-abiding parent company (U.S. or foreign), recognizing that whatever price it may charge a controlled entity may be challenged by the IRS, given the absence of definitive rules, is likely to select the price at the lowest and/or the highest end of a legally proper range of prices it believes to be to its advantage so that it will have room for negotiation if challenged. This was frankly recognized by a senior IRS spokesman at the 1990 hearings[53] and in the 1992 report on section 482.[54] It is also strongly suggested by the IRS' singular lack of success in winning large cases under section 482. This evidence, however, has not been translated by Treasury, IRS, and congressional policymakers into efforts to develop rules that would shed light in the existing darkness.

6. Uncertainty of Business' After-Tax Returns

The inability of a business investor or manager to forecast with reasonable certainty the level of taxes on commercial returns from international transactions is the other side of the coin that prevents governments from estimating tax revenues from international business. However, the consequence in the private sector may be a dampening of investors' willingness to undertake risks associated with possible international ventures, with consequent diversion of capital to other ventures offering surer returns.

7. Enormous Compliance Cost

Fees that international business firms must pay private sector professionals for work on a large transfer-pricing tax case can be enormous. Imagine the professional fees that must be paid to tax professionals over the period of perhaps 10 years that may be required to take a case through each country's audit, administrative appeals, trial and appellate litigation, and finally to international negotiation between competent authorities representing each country's tax agency.[55] Business also must pay substantial amounts for the time expended by executives and other personnel on transfer-pricing cases.

The only winners under Treasury's current arm's-length pricing approach are the many professional middlemen—accountants, tax auditors, lawyers, economists, valuation experts, technical information publishers,[56] and other professionals. The big losers are the principal parties in interest, international businesses and the countries. Governments incur high enforcement costs and also lose revenues that could be collected under a set of clearer rules. Their economies suffer from having resources diverted to the private sector's costs for compliance. Because of this, both private and public sector officials would be well-advised to institute a far less costly system.

a. Two-class justice.

This burden is one that could scarcely be afforded by small businesses attempting to follow the proposed regulations. While a larger enterprise may be able to better afford such costs, it is hardly in the interest of a large enterprise or the public to require the enormous expenditure of resources, public and private, that continuation of the existing state of affairs would require. It is also undesirable to have a system of tax justice that operates one way for large businesses and another way for smaller businesses.

In recent remarks to the Tax Executives Institute, IRS Commissioner Shirley Peterson said one of the three principal goals of the Service is to reduce the burden on taxpayers.[57] The same goal was also embraced by Treasury Assistant Secretary Goldberg, in the press release announcing the Treasury/IRS business plan for 1992.[58] The approach of the existing Treasury regulations, and that of the proposed regulations, hardly seem to satisfy that goal. We submit that that goal will not be achieved as long as the existing policy direction is continued. That policy direction and that goal are incompatible.

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[53]*See* testimony and written statement of the Service's Deputy Associate Chief Counsel (International) Charles S. Triplett at the 1990 hearings, *supra* note 2, at 103 and 95, which is discussed in Wickham, "Transfer Pricing," *supra* note 6, at 21.

[54]*See* 1992 Treasury Report, *supra* note 13, at 3-6.

[55]Eight or more years is specified by Treasury and the Service in their 1992 report on section 482 as the time required to resolve "a significant section 482 issue." *See* 1992 Treasury Report, *supra* note 13, at 3-5.

[56]The launching earlier this year of a privately financed publication devoted to furnishing information on developments in the transfer-pricing area is one reflection of the magnitude of the problems in this area. The new publication is BNA's *Tax Management Transfer Pricing Report*.

[57]*Infra* note 72.

[58]*See* text *infra* at note 72.

8. Enforcement Costs

Neither the total costs incurred nor the revenue benefits received by the U.S. government in connection with administration and enforcement of Treasury's current or proposed arm's-length pricing regime under section 482 have ever been published, so far as we are aware. Fragmentary elements occasionally are reported.[59] The IRS and Treasury, by questionably determining that the proposed regulations under section 482 are not major rules, have avoided a cost/benefit Regulatory Impact Analysis required under Executive Order 12291.[60]

The available evidence indicates that the magnitude of the system-wide costs of the U.S. government for administration are enormous, and growing dramatically. The 1992 Treasury Report gives a clue to the magnitude of the expenditure of public resources required by the current case-by-case approach. Two cases were described that involved use of the new advance pricing agreement (APA) procedures. In Case 1, the IRS district spent approximately 2,100 hours of international examiner (IE) time developing the issue and, in contrast, following subsequent APA negotiations, the parties resolved all transfer-pricing issues covering all product lines for eight years (including six back years). The entire process consumed 1,900 professional hours, including 1,000 hours of IE time and 900 hours of attorney time. That APA is pending competent authority resolution. In Case 2, the IRS district spent approximately 5,000 hours of IE time developing the issues, and in contrast, the district had spent approximately 500 IE hours on the two APA proposals for this taxpayer that are pending competent authority resolution. It was anticipated that the taxpayer and the district will use certain key APA concepts to resolve the remaining transfer-pricing issues in at least six of the taxpayer's prior tax years.[61] Remember, the hours described in the Treasury report were expended with respect to only two groups of taxpayers. Multiply either by the hundreds, if not several thousands, of other controlled groups of taxpayers, and it soon becomes apparent that the cost of continuing the present case-by-case approach can overwhelm Treasury and the Service. The proposed regulations will not resolve this problem. They continue the case-by-case approach.

We note that the president recently extended his 90-day freeze on most new regulations by four months, and ordered government agencies to start using cost/benefit analyses when evaluating legislation or proposed rules.[62] We suggest that those requirements be applied to the IRS and Treasury and that they determine and account publicly for the costs of adhering to the present case-by-case approach under section 482. More specifically, we suggest that the IRS and Treasury be required to report to the Office of Management & Budget, Congress, and the public on the annual and cumulative dollar costs of the government for administration and enforcement of section 482. This should take into account not only the direct hours of the professionals involved and their respective compensation through the litigation process (victories and defeats), but also an appropriate part of all other properly allocable costs, including the costs of secretarial assistance, management, and overhead. The costs taken into account should include those incurred for developing the newly proposed regulations for evaluating the comments on them, and for developing the final regulations. The costs should also include those incurred in developing the APA procedures, and the costs heretofore incurred and expected to be incurred in the future in negotiating such agreements (i) with various taxpayers who seek such agreements and (ii) with the relevant foreign jurisdictions, and the costs of monitoring such agreements. The cost should also include the likely costs of enforcing the proposed regulations if they were to be adopted. That would include not only the costs for identifying the comparable companies in the construction of a comparable profit interval in the audit of any given taxpayer, but also the cost of obtaining all of the data from various other sources described in the 1992 Treasury Report, as needed for that purpose. All are part of the costs of the present system and should be taken into account in evaluating its policy.

These costs for administration and enforcement of the present approach should then be compared with the costs that could be expected under a new system of generally applicable rules reducible to numbers required on tax returns. Without having done all the work described to make an appropriate cost/benefit analysis, we think the evidence already available strongly suggests that a comparative

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[59] *See*, e.g., the reported costs of the Service for procurement in fiscal 1991 of expert witnesses for use in section 482 cases, as well as a reported tax adjustment of $30 million in one case which the Service and Treasury chose to relate to use of an expert witness. 1992 Treasury Report at 2-10 and 11. *See also* the written statement of Commissioner Peterson presented at the 1992 hearings that presents (at pages 4 and 5) further information on the costs of expert witnesses, indicating that $14.6 million was spent for them in 1992 and stating that tax adjustments of $766 million arose from settlement of three of nine cases in which expert witnesses provided assistance at the examination level.

[60] IRS/Treasury Notice of Proposed Rulemaking, 57 Fed. Reg. 3571 at 3578 (proposed Jan. 30, 1992).

[61] 1992 Treasury Report, *supra* note 13 at 3-3 and 3-4.

[62] *Wall St. J.*, April 30, 1992, at A-2. *Also see* 84 *Daily Tax Report* (BNA) G-13 (April 30, 1992).

cost/benefit analysis would argue for a new system.

9. Disclosure of Sensitive Information

Taxpayers, their competitors, and others are now required to disclose confidential financial and sensitive business information. This disclosure needlessly generates enormous difficulties. These difficulties include (a) the high cost of acquiring the information; (b) breach of the information suppliers' confidences; (c) the use of evidence not subject to a taxpayer's cross examination; and (d) the demand for information about competitors' pricing and internal affairs, which, if directly sought by conscientious taxpayers' executives through communications with competitors' representatives would, we are advised by antitrust counsel, risk criminal violation of section 1 of the Sherman Antitrust Act.

10. Disparate Treatment of Competitors

There is a very real potential for disparate and anticompetitive tax treatment of business competitors implicit in any tax regime that relies not on published and principled rules of general applicability but on a case-by-case approach. The tax exacted in each case is set by revenue officials without the guidance of generally applicable rules. This potential is aggravated by the new APA procedures as we note further below.

11. Discord Among Nations and Between Taxpayers and Tax Authorities

Recent events indicate the potential of the present transfer-pricing tax system for generating discord, both internally within the United States and internationally. Within the United States, the hearings in 1990 and 1992 before the House Ways and Means Oversight Subcommittee provide extensive evidence of the present system's potential for encouraging discord among several major groups. The Treasury's unyielding advocacy of the vague arm's-length pricing system, combined with congressional acceptance of Treasury's assertion that other internationally accepted methods do not exist, has pitted Treasury and the IRS against Congress in a growing confrontation. Members of Congress charge that Treasury and the IRS are failing to do what they should; Treasury and the IRS defend their work by asserting they have limited resources but could do a better job if provided with financial support and enforcement powers to pursue heavily financed and well-represented tax delinquents.

> The available evidence indicates that the magnitude of the system-wide costs for administration are enormous, and growing dramatically. We suggest that the IRS and Treasury provide a cost/benefit analysis under Executive Order 12291 and account publicly for the costs of adhering to the present case-by-case approach under section 482.

The vagueness and lack of rules also leaves Congress, Treasury, and the IRS free to question whether the United States is getting its fair share of income tax revenues from international business transactions. Since the rules needed to answer this important question do not exist, erstwhile combatants in Congress, Treasury, or the IRS are free to join with one another or not in challenging the tax bona fides of foreign-controlled business enterprises, if not foreign governments themselves. That in turn opens the way for charges and countercharges of excesses, or tax abuse or tax evasion by large international business taxpayers (either U.S. or foreign), and the need for extraordinary tax penalties or for criminal prosecutions. The scenario described leaves little room for the combatants within the U.S. government to join publicly in discussing the extent to which they themselves may be responsible for the lack of rules needed to resolve the questions raised. It also leaves little room for them to discuss the extent to which they might effectively join with foreign governments in the hard task of arriving at the internationally agreed rules needed to resolve conflicts that really are among themselves more than between each of them and the international business firms. The firms are to some extent only stakeholders.

The potential of the present system for domestic partisan discord and for destructive international tax warfare could hardly be more vividly indicated than by *The Wall Street Journal's* recent headline. It reported that one presidential candidate would make U.S. operations of foreign-controlled business enterprises targets for income taxes needed to reduce the U.S. budget deficit. The same is true of a provision in the 1992 Foreign Tax Bill. It would impose a minimum U.S. income tax on gross receipts of U.S. operations of businesses controlled by foreign interests. This tax would be imposed whether or not the foreign parent and its U.S. subsidiary together showed a combined profit or loss and whether the tax would violate international tax treaty obligations of the United States against discriminatory taxation of foreign treaty partner business enterprises.

Needless to say, the potential of the present system for generating discord among such major interest groups is due in major part to the vagueness of Treasury's rules under the present arm's-length transfer-pricing system for determining what transactions are really comparable for setting the right price in the absence of comparables. It is also due, however, to the dearth of internationally agreed rules for harmonizing multinational claims to income taxes on international transactions. Clearly, this potential for major discord can be reduced by governments' acting cooperatively on a long-term basis to reach international accord on the kinds of clear rules needed to permit harmonious resolution of conflicts.

12. Advance-Pricing Agreement Procedures

Last year, Treasury and the IRS instituted, with great fanfare, the new APA procedures. These are procedures by which a particular controlled group of taxpayers and the IRS, and possibly tax authorities of involved treaty countries, conduct secret negotiations and arrive at a secret agreement, made in advance of a series of international business transactions planned by the taxpayer group, to govern the methodology for establishing prices that will be accepted by the taxing authorities as arm's-length transfer prices for sales of a particular product line (or lines) for three or fewer specified years in the future. These procedures were adopted for the avowed purposes of reducing after-the-fact litigation and controversies over transfer prices and of gaining the benefits of greater certainty of tax results and lower tax compliance and administration costs that can flow from resolving differences before a particular line of business is carried on by a taxpayer.

The new APA procedures have merit insofar as they accomplish their avowed purpose of reducing controversy and costs of tax compliance and enforcement. They also have merit insofar as they frankly recognize that the costly controversy that may result from lack of advance rules will frequently be between tax authorities as well as between taxpayers and the IRS.

There is, however, a great deal that the APAs do not do—and cannot be expected to do. There is also a great deal of damage they can do as a result of some new problems they add to a system already seriously overburdened with major problems. What the new APA procedures do not do would be far less significant if the IRS and Treasury were not expending the major technical and public relations resources to publicize and encourage the use and adoption of APAs as a reason for not making more fundamental changes that have some prospect of solving root problems in the area.

What do the new APA procedures not do? This may be answered by testing APAs in the light of their tendency to resolve the core and derivative problems under the present system we have described earlier in this paper. They do not abandon the case-by-case aspect of the Service's approach; instead, they insist on it. They fail to supply the pressing need for prepublished rules of general and equal application to all taxpayers. They thus deprive all people and countries subject to the present arm's-length transfer-pricing tax regime of the enormous benefits to all that can flow from a system for voluntary taxpayer self-assessment of tax. The Service's publication of some generic guidelines with respect to the advance-pricing procedures, as the commissioner and the 1992 Treasury Report promise, would be modest steps in the right direction. However, guidelines are no substitute for clear, prepublished, and generally applicable principles of law. The advance-pricing process will still be a case-by-case approach, reminiscent of the experience under the 1968 guidelines under an earlier version of section 367,[63] which requires an enormous expenditure of resources to follow an errant policy.

The APA procedures also fail to designate acceptable methods, from among several available, as alternatives to the arm's-length pricing method. They divert limited time and energy of tax policymakers and enforcement personnel away from endeavors that promise far greater public return on the investment. The international tax counsel of General Electric Co. was quoted recently as saying that while APAs will help some taxpayers reduce uncertainty, they are not practical for relatively large companies. He reportedly advised that GE alone, which has 13 affiliates worldwide, "would keep the government busy for the rest of the century if we pursued APAs."[64]

What are the additional problems generated by the new APA procedures? Because they apply case-by-case and are so time-consuming and costly for taxpayers and governments, they can only aggravate the disparities and lack of even-handedness in treatment of taxpayers that are inherent in any case-by-case approach not guided by rules of general application. Winners will be found only among the relatively small number of larger business taxpayers that can afford the costs, while the losers will include the vastly larger number of smaller business taxpayers who cannot afford the costs of this and are deprived of the benefits of prepublished rules of general application.

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[63] *See* Rev. Proc. 68-23, 1968-1 C.B. 821

[64] Remarks of Mark Beam in New York City on April 27, 1992, as reported in 1 *Tax Management Transfer Pricing Report* 4, at 25 (May 1, 1992).

Even more serious, however, the new APA procedures are secret, enhancing the potential for disparate treatment of competitors and for unequal application of our tax laws as between domestic-and foreign-controlled international businesses. APAs are the result of secret negotiations between taxpayers and tax collectors, and meetings between countries' taxing authorities from which interested taxpayer representatives are excluded, in proceedings that may involve sums that are large for all parties. While APAs may provide a given taxpayer some measure of certainty for a limited period of years and for the transactions in products subject to that agreement, they provide no guidance to the rest of the world as to the applicable principles of law. Secret agreements, coupled with the absence of published principles of law, result in *ad hoc* agreements that in turn create the potential for disparate treatment of competitors. Would it be acceptable for the IRS to enter into advance agreements about methods of pricing for income tax purposes for one line of computer products sold by Apple while it does not do so for competing lines of computer products sold by IBM or by NEC? If not, how, under the present system, would any independent authority be able to monitor such activity of the Service? We ought not repeat the course of action rejected by the Court of Claims in the *IBM* case,[65] where the IRS granted one company a favorable excise tax ruling that it denied a business competitor for competing products.

The new APA procedures amount to an invitation to large international business taxpayers: "Let's make a deal, a secret deal, about the method to be used for determining your income taxes." That undercuts the appearance of integrity and even-handedness that is so vital to public acceptance of, and voluntary compliance with, our tax laws.

This problem is especially aggravated when senior tax officials publicly comment on the high tax penalties and other costs that may be suffered by taxpayers who fail to avail themselves of the benefits the new APA procedures can offer.[66] Taxation by secret negotiation and agreement instead of by prepublished rules of general application is not the tradition in this country and does not comport with its democratic political values.

We also strongly urge that the IRS, without waiting for such new principles of law, be compelled legislatively to publish sanitized versions of all APAs from which confidential and sensitive business information has been removed as is done with private letter rulings. However, publication of sanitized APAs can only be a stop-gap measure and is not a substitute for adoption of prepublished rules of general application.

13. Heavy Taxpayer Burden

Judicially developed procedural tax law, as we noted elsewhere,[67] imposes an extraordinarily heavy burden on the taxpayer of proving pricing adjustments to be arbitrary, capricious, or unreasonable. It does so without the taxpayer's being given the benefit of an advance statement of what is expected and reasonable. The "scales of tax justice are thus weighted sharply in favor of the U.S. tax collector's exercise of the enormous power associated with the vagueness of the standard prescribed in the statute and in the existing Treasury regulations under section 482".[68] We also observed, "That may help explain a long-standing reluctance on the part of . . . tax officials to abandon the present regulatory regime: doing so would entail relinquishing the enormous and loosely constrained power they now have to dispose of section 482 issues on a case-by-case basis."[69] The propriety of attaching more than the usual presumption of correctness to the IRS' determination of a tax deficiency is fairly open to question as a matter of law, even constitutional law, where the standard pursuant to which the deficiency determination is made is as vague as under the arm's-length transfer-pricing approach.[70] As a matter of policy, the wisdom of attaching more than the usual presumption of correctness and of providing the IRS such additional incentives for litigating a section 482 case is highly questionable. Some would change this by changing the present burden-of-proof law.[71] The need for such changes would be obviated by Treasury and the IRS' adoption of clear new substantive rules reducible to numbers required on tax returns.

III. Alternatives That Are Not Solutions

A. More of the Same

Policymakers for many years have advocated, and the U.S. Congress has acquiesced in, the case-by-case approach. Since 1988, Treasury and IRS policymakers have given

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[65] *International Business Machines v. United States*, 343 F.2d 914 (1965).

[66] *See*, e.g., 1992 Treasury Report, *supra* at note 13.

[67] *See* Wickham, "Transfer Pricing," *supra* note 6, at 29.

[68] *Id*. at 29.

[69] *Id*. at 29.

[70] Constitutional due process generally requires that "ascertainable standards" be treated as "an elementary and intrinsic part of due process," *Environmental Defense Fund v. Ruckelshaus*, 439 F.2d 584, 598 (D.C. Cir. 1971); *see also Holmes v. New York City Housing Authority*, 398 F.2d 262, 265 (2d Cir. 1968) and Davis, 2 *Administrative Law Treatise* (2d ed. 1979) 131. The void-for-vagueness doctrine may also support a constitutional challenge, especially in respect to the recently enacted penalties for substantial misstatement of transfer price imposed under IRC section 6662(e).

[71] For a summary of and comment on some of these proposals, see 1988 White Paper, *supra* note 14, at Chapter 9.

priority to enlarging IRS enforcement capabilities over modification of the substantive rules. They have urged Congress to provide increasing support, in money and enforcement powers, for their continued use of the arm's-length transfer-pricing regime. They have steadfastly resisted suggestions that they abandon or move away from it. They have explicitly rejected repeating pleas for clarification of that regime by adoption of rules that are reducible to the numbers required on tax returns.[72]

In the international transfer-pricing area, case-by-case enforcement is the problem to solve, not a solution. Case-by-case is where one starts, before one has rules providing more generalized, and less expensive, solutions to issues of how much tax is to be exacted from each taxpayer on the facts of each case. The objective is to get beyond the case-by-case necessity from which one starts and to develop rules of general application that provide guidance sufficient to permit reasonably conscientious taxpayers to prepare their tax returns with confidence that they have done what the tax law requires. Only in that way can we realize the major reductions in enforcement and compliance costs associated with the U.S. system for voluntary taxpayer self-assessment of income tax. Only in that way can taxpayers, tax collectors, and policymakers alike have confidence that taxes imposed are actually being paid or not paid. Only in that way can we be assured that the amount of tax collected from each taxpayer is exacted according to some standard of general application that fits our notions of fairness and equality of treatment, instead of being an arbitrary imposition of a tax official who is free to take a position without accountability to any clear-cut rule of law in the light of which a court or other independent authority can review the legality and propriety of the action imposing the tax.[73]

For these reasons, Congress, our citizens, and our trading partners should reject the IRS' quest for more power. We simply can't afford it. Procedures for APAs, programs for stepped-up enforcement activities in audit or in litigation, and programs for intensified information reporting or exchange of information among taxing authorities cannot function as substitutes for the principled new rules of substance that are so badly needed in this area.

The IRS has urged that time be allowed to field test the results of the new enforcement money and requested powers. This need for field testing has been urged as a reason to delay legislative change. We believe that such grounds should be rejected. We don't have to spend

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[72]That a case-by-case, after-the-fact approach is undesirable and outmoded is recognized by Commissioner Peterson in remarks she made recently describing a new Service program called "Compliance 2000." She described that program as "a new way to think about the administration of the tax law." She acknowledged that "the Service's traditional approach to compliance has focused on "after-the-fact" activities," that the Service "generally enter[s] the picture after the return is filed (or not filed), after the mistake has been made, [and] after the money is owed. She reported that" [t]his philosophy has bred programs that focus on compliance on a case-by-case basis" and that "[t]his approach generally produces a correct individual tax result but often leaves unaddressed the reason or motive for the original noncompliance." She acknowledged that "Compliance 2000" "recognizes that a good part of what we call noncompliance with the tax laws is caused by the taxpayer's lack of understanding of what is required in the first place," and advised that, "[g]iven that reality, it makes better business sense to help broad segments of taxpayers comply." Remarks of Commissioner of Internal Revenue Shirley Peterson, made on April 1, 1992, in Washington, D.C., before the Tax Ececutive Institute. *See* 92 *TNT* 71-21 (April 2, 1992).

Similar views recognizing that uncertainty in tax law and litigation are not in the public interest were also expressed by Treasury Assistant Secretary Goldberg in another connection, where he stated that "[t]he current regime for taxing purchased intangibles leads to frequent and expensive controversies between taxpayers and the Internal Revenue Service; and deprives the federal government of substantial tax revenues that are properly due and owing." He acknowledged that "[n]o amount of after-the-fact enforcement and litigation can remedy the situation—legislation is essential if we are to eliminate this source of waste, inefficiency, and controversy." Statement of Treasury Assistant Secretary for Tax Policy, Fred T. Goldberg, Jr., before the Senate Finance Committee at hearings on proposed legislation (H.R. 3035) relating to the tax treatment of purchased intangibles. Those comments about after-the-fact enforcement and litigation as a source of waste, inefficiency and controversy seem to us to be equally applicable to the current regulatory regime under section 482.

Secretary Goldberg also remarked recently in reference to a business plan that was released by Treasury and the Service on May 15, 1992, and that sets regulatory and other administrative priorites for the remainder of the year, that "[t]ax policy must be guided by the public it serves. We want to provide taxpayers with the certainty needed for business transactions. By establishing our priorities, the government can be held accountable by the public." 55 *Tax Notes* 1008 (May 25, 1992). 55 *Tax Notes* 1155 (June 1, 1992). A press release accompanying the business plan also stated that "[w]ithin the framework of existing law, our overall objectives are to enhance voluntary compliance and reduce taxpayer burden." 92 *TNT* 104-150 (May 18, 1992). We believe that continuation of the existing approach under section 482 would be inconsistent with the objectives of the business plan. It certainly does not provide certainty for business transactions nor does it reduce the taxpayer's burdens. The proposed regulations are likely to create more uncertainty and increase the taxpayer's burdens.

[73]Chief Judge Nims of the U.S. Tax Court, in commenting on a "rather troubling" statement in a 1989 congressional committee report that the conferees had been informed that the Tax Court was "substituting its judgment" for that of the commissioner in reviewing section 482 cases, stated: "I wish to assure Congress and all others that the Tax Court has no intention of routinely substituting its judgment for that of the tax administrator. Nevertheless, many of the cases we've been talking about involve hundreds of millions of dollars, sometimes determined by the commissioner in the most generalized way, and in a free society such as ours, it is essential that review by an independent tribunal like the Tax Court be available. And nothing must be done to undermine that independence." Remarks of Judge Arthur L. Nims III, in Chicago before U.S.A. branch of International Fiscal Association (March 1, 1991), quoted and discussed in Wickham, "Transfer Pricing," *supra* note 6, at 23-25.

years of empirical field testing and millions if not billions of dollars to know that the case-by-case approach is a problem that the public interest requires to be solved, not embraced.[74]

B. Proposed Regulations Intensify Problems

In their presentations to the House Oversight Subcommittee at the hearings held in April of this year and in their simultaneous report to Congress on section 482, Treasury and IRS policymakers cited their newly proposed substantive regulations as one of their administrative steps for enforcement of section 482 that would make "[a]dditional legislative changes . . . premature at this time."[75]

We disagree. As we have developed earlier, the proposed regulations do not even purport to solve the core problems that are at the root of the major difficulties being experienced in the area. We suggest that statements or implications to the contrary should be dismissed by Congress and be viewed instead as a declaration by Treasury and the Service of their intention to continue their costly insistence on permitting only their arm's-length pricing standard to be used.[76]

C. Unilateral Measures Offer Only Partial Solutions

As we have noted earlier, some of the major problems under the present system can be remedied by unilateral action. Thus, we have noted a number of administrative or legislative actions that could be taken unilaterally by the United States that could effect important reductions in the high level of difficulties now being experienced. Some of the problems, however, are soluble only by international agreement. This is particularly true of issues concerning fairness of the share of revenues derived by each of two or more countries from the same international business transactions. Accordingly, international agreement among competing taxing jurisdictions is required to secure more than a partial solution to conflicts among countries' substantive or procedural rules pertaining to allocation of the base for taxing income from international transactions. That is true whether the rules involved relate explicitly to jurisdiction to tax income, to allowance of a credit against tax of the domiciliary country for tax of the source country, or to a domiciliary country's exercise of a section 482-type power in a manner that conflicts with source rules.

To some this point is obvious; to others it is not. Perhaps that is because of a habit in the United States for so many years of thinking only in terms of what the United States can do legislatively or administratively to change its tax approach to international businesses. Whatever the reason, the result is that proposals often are put forward as alternatives for solving problems in this area without recognition that they can be only partial solutions to problems that require international agreement. This is true, for example, of transfer-pricing proposals in the 1992 Foreign Tax Bill aimed at assuring the United States its fair share of income tax from international business transactions. Our tax policymakers in the United States need to understand that there are distinct limits to what can be accomplished by just talking to ourselves. We must also talk with our trading partners if we are interested in establishing internationally agreed standards for determining the fairness of respective national shares of the international income tax base.

D. Unadministrable Rules

An agreement is not effective to bind the parties and is not enforceable if the subject matter of the agreement does not exist. The agreement is illusory. An agreement to divide taxing rights by reference to a comparable arm's-length price is similarly illusory if the comparable arm's-length price does not exist, or if it exists but cannot be found.

Similarly, an agreement is not effective to bind the parties and is not enforceable if it is so vague or ambiguous in meaning that arbitration authorities are unable to accord the language of the agreement an interpretation that can be reduced to practice in a way the parties can fairly be said to have intended.

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[74]Congress eliminated the anachronistic case-by-case approach formerly required for transfers subject to section 367 for reasons that are also applicable here under section 482. It did so initially with respect to section 367(b) in the 1976 act, and with respect to section 367(a) in the 1984 act. In 1976 Congress concluded that the case-by-case approach was no longer satisfactory with respect to transfers under section 367(b). It required that the regulations prescribe more definitive rules to guide taxpayers. Congress enacted changes in the statutory provisions of section 367 in the 1976 act to avoid the necessity of case-by-case tax avoidance determinations theretofore required in certain transfers. H.R. Rep. No. 94-658, 94th Cong., 1st Sess., 241 (1975) "TRA 76 House Report"; 1976-3 C.B. 931 at 953 S.Rep. No. 94-938, 94th Cong., 2d Sess., 261 at 263 (1976). 1976-3 12 C.B. 299 at 301. The explanation of that legislation in the Joint Committee Staff's "Blue Book" reported that "[t]he Congress further believes that the interpretation of the rules governing exchanges described in section 367 should not be done in individual rulings but should be provided by clear and certain regulations," that "unnecessary barriers to justifiable and legitimate business transactions should be avoided," and that "[t]he Congress believes that U.S. taxpayers participating in certain types of transactions involving foreign corporations should be able to determine the tax effect of the transaction from the statute and accompanying regulations rather than being required to apply to the Internal Revenue Service for a determination in advance of the transaction." Staff of the Joint Committee on Taxation, "General Explanation of The Tax Reform Act of 1976 (H.R. 10612, 94th Cong. 2d Sess., Public Law 94-455)" at 258 and 259 (December 29, 1976).

[75]"1992 Treasury Report," *supra* note 13, at "Executive Summary," item (c).

[76]To the contrary, the "1992 Treasury Report" stated that "[t]he proposed regulations also respond to Congressional concerns that more rigorous standards should apply in choosing the comparable data used to justify the consideration charged in a controlled transaction. *Id*. at 4-1.

The considerations just noted are relevant not only to the binding status of Treasury's arm's-length pricing interpretation of international agreements now in place but also to objectives to be set regarding the content of new international tax agreements that are to be sought. To be effective, an international agreement dividing rights to the taxation of income from international business transactions should rely on existing and known factors that permit the reduction of principles to finite numbers required on income tax returns.

IV. Possible New Directions for Solutions

Generally, the new directions we suggest require a shift in the U.S. policies with respect to each of the core problems identified above. We recognize that new directions, while solving some of the problems, will allow others to exist and may also generate new problems. We also recognize that there will always be problems of interpretation. With such recognition, we nevertheless suggest for consideration new directions that may be summarized as follows:

- Shift away from a system having intentionally vague, *in terrorem* rules or no rules at all to one that prescribes definitive rules that are readily reducible to numbers required in tax returns.
- Shift away from requiring focus on the right price for an internal, non-arm's-length transaction among members of a controlled group and instead, disregard such intercompany transfers, and concentrate on geographically allocating combined profit or loss realized by the group.
- Focus on developing a single, new set of unified source rules for geographically allocating profit or loss on terms that are the same for unincorporated branches and incorporated subsidiaries and that are meshed with rules under section 482.
- Focus on formulating and obtaining the needed multinational agreement on rules for harmonizing and resolving conflicts among competing multinational tax claims to income from international sales of goods or services, especially (a) substantive rules for geographically sourcing or allocating profit and (b) procedural rules establishing a framework for resolving conflicts among multinational interpretations and applications to specific cases of substantive sourcing and jurisdictional rules.

> The U.S. should abandon the established practice of not prescribing rules of general application that are reducible to numbers on tax returns. It should act unilaterally, without further delay, to propose and then to promulgate rules that clearly state what is expected.

The new directions we suggest are discussed in more detail in the materials that follow.

A. Rules Instead of No Rules or Illusory Rules

The United States should abandon the established practice of not prescribing, and not committing in advance, to definitive, workable, and publicly promulgated rules of general application that are reducible to numbers on tax returns and meet the needs for guidance of all concerned. Instead, the United States should act unilaterally, without further delay and within publicly committed time deadlines, to propose for public consideration and then to promulgate in final form, definitive, specific, workable, and prospective rules that clearly inform taxpayers, tax officials, and judges what is expected for (i) determining and reporting net income or loss from international business transactions which involve one or more members of a commonly controlled group and for (ii) allocating the net income or loss from any such transaction to countries of source. The proposed regulations under section 482 that were released in January of this year do not satisfy this standard and amendments necessary to meet the standard should be published promptly for public consideration.

Preferably, this task would be accomplished administratively to the maximum extent possible by amending regulations under section 482, publishing revenue rulings and revenue procedures, and pursuing international consultations—all within time constraints commensurate with the urgency of the problems presented. Congress is neither equipped nor constitutionally positioned to take administrative action or to obtain the ensuing multinational agreements that are needed.

If, however, Treasury and the IRS fail to act, Congress should set deadlines and enact legislation implementing clear and workable new rules that would be an appropriate starting point for an internationally harmonized regime.[77]

[77]We do not share the view recently attributed to former Assistant Treasury Secretary Gideon that Congress has few alternative courses of action other than a formula approach. 1 *Tax Management Transfer Pricing Report* 5 at 6 (May 13, 1992). We think it would be preferable for Treasury to lead the way. If it continues not to, however, we think there are many options open to Congress for using its powers to correct directions of the U.S. policy in this area to move toward more workable methods for geographic apportionment.

Congress took action with respect to section 367 to negate the case-by-case approach under section 367. If there is a continued failure by Treasury and the IRS to abandon the case-by-case approach under section 482, Congress should take corresponding action as needed with respect to rules under section 482.[78]

B. Arm's-Length Pricing Not Exclusive

The new substantive rules adopted by the United States should abandon an attempt to establish a hypothetical tax price or a constructive operating profit for a given party.[79] These new rules at the very least should permit use of other arm's-length methods that do not require to resort to comparables or construction of hypothetical prices for intercompany transactions. That change alone would do more than perhaps any other single action to reduce mounting problems in the area, and it can be unilaterally and quickly effected by amending the pending proposed regulation. The new U.S. rules should permit and define methods for determining and then allocating to countries of source the combined arm's-length profit or loss derived by a controlled group from transactions concluded at arm's-length with unrelated parties.[80] The new rules should authorize a split of the participants' actual (as distinguished from a constructive) arm's-length profit or loss, using for the split definitively specified and weighted factors from among rules of source described further below. The rules used would fix the geographic locale of the particular business activities, assets, personnel markets, and other factors on which the country bases its claim to tax a portion of the income generated by that business.

Technical changes to the Treasury regulations under section 482 to implement the approach suggested should include those needed to achieve the following:

(1) To determine on an arm's-length basis true taxable income from any international transaction (or series of transactions) involving more than one member of a controlled group —

(a) Allow actual combined taxable income or loss of a controlled group from a transaction or transactions concluded at arm's length with an unrelated party to be computed as if the participants of that group in the transaction were a single entity;[81]

(b) Disregard or eliminate any intercompany transactions among members of the controlled group and do not treat any such intercompany transaction as an event requiring recognition of gain or loss for income tax purposes;

(c) Do not require that a price at arm's length be established in respect of any intercompany transfer of property or services among members of the controlled group.

(2) Allocate the combined taxable income or loss of the participating members of the controlled group as thus determined from a given transaction (or series of transactions) at arm's length to geographic sources within the United States and to sources in countries without the United States, using such of the modified new rules of source recommended and described further below as are selected and specified for this purpose.

(3) Also allocate such combined taxable income or loss of the participating members of the controlled group among appropriate members of the controlled group that participated in the transaction at any stage, using such modified source rules for that purpose also.

Identifying the geographic source of an item of income or an item of deduction is likely to identify the member of the controlled group to which the item should be allocated. That is the way that items

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[78]*See*, for example, the comments of Patrick Heck, House Oversight Subcommittee Assistant Counsel, made before a conference of the American Tax Institute in Europe held in Paris, reported in 114 *Daily Tax Report* (BNA) G-1&2 (June 12, 1992).

[79]This does not mean that an arm's-length standard for determining profit or loss should be abandoned. Taxable profit or loss is commonly determined by tax accounting methods that disregard transactions among related parties and take account only of transactions at arm's-length.

[80]This approach is used in a limited context in section 203 of the 1992 Foreign Tax Bill, *supra* note 17.

[81]The suggested concept of treating an entire controlled group as a single entity for such a single purpose is hardly new to the tax law. There already are various provisions under which (i) interest expense, (ii) all expenses (other than interest) which are not directly allocable or apportioned to any specific income-producing activity, and (iii) certain research and development expenditures, are to be determined, allocated and apportioned as if all of the members of an "affiliated" group were a single corporation. *See* IRC sections 163(j)(60)(c), 864(e)(1) and (6), and 864(f)(4). This suggestion is also analogous to the approach used in determining the combined taxable income from a given transaction of a foreign sales corporation (FSC) or the earlier domestic international sales corporation (DISC) and its related supplier.

The approach suggested also is used in section 203, the 1992 Foreign Tax Bill, *supra* note 17. *See also* section 101 of that bill. It provides that taxpayers may take into account the interest expenses and assets of foreign subsidiaries for purposes of allocating and apportioning interest expenses between gross income from U.S. sources and foreign sources. In addition, the bill would expand the types of corporations that are treated as financial institutions for purposes of applying the one-taxpayer rule separately to financial institutions in a related group.

Further, section 201 of that bill would generally repeal deferral on controlled foreign corporations by treating as subpart F income generally all of a controlled foreign corporation's earnings and profits for the taxable year. According to the statement explaining that provision, under the bill, the code retains much of present law solely to preserve the tax treatment applicable to earnings and profits (and deficits in earnings and profits) attributable to years beginning prior to the effective date of the bill.

The Service already has the powers to require foreign as well as domestic entities to report the information and to furnish the records that are needed to audit the combined taxable income or loss reported by the taxpayer. *See*, e.g., IRC sections 6038, 6038A, 6038B, and 6038C.

of income and items of deduction are allocated to a branch. The taxable income effectively connected to a branch is determined first; then the remaining items not allocable to the branch are allocated to the balance of the enterprise of which the branch is a part.

(4) As under existing law, determine U.S. tax by applying the U.S. tax rate, in the case of a foreign member of the controlled group, only to the U.S.-source portion of the combined taxable income, and then reduce the tentative U.S. tax by a foreign tax credit allowable by the United States for foreign taxes on the foreign-source portion of the combined taxable income, using for these purposes, however, the unified set of modified-source rules recommended and described below.

Precedents

The approach suggested is consistent with the arm's-length standard. Similar approaches already treated as being consistent with an arm's-length standard include the following: (i) the profit-split method as applied by the IRS on audit after a functional analysis where none of the three earlier methods of determination is applicable; (ii) the profit-split method applied by the courts (even where the existing Treasury regulation requires an arm's-length price);[82] (iii) the "commensurate with income" method required in section 482 for intangibles; and (iv) the profit-split method applied by Treasury in the White Paper in allocating residual income, after application of the basic arm's-length rate of return method ("BALRM") to measurable factors attributable to each of two related parties each of whom has a valuable intangible that cannot be readily measured.[83]

The approach suggested is consistent with viewing those members of a control group who participated in a given transaction as members of a joint venture with respect to that transaction. As we see it, the problem is one of allocating the profit or loss from a given transaction derived by the joint venture among those members of a control group who participated in it. The starting point should be the profit or loss realized by the joint venture in the given transaction with an unrelated party. The approach is consistent with an arm's-length standard, since independent parties do enter into joint ventures with other independent parties. That was the rationale recognized by the White Paper in requiring a profit split of the residual income from a given transaction (remaining after application of the BALRM) in those circumstances in which each of the two members of the control group owned valuable intangibles that were involved in the given transaction.[84]

The approach suggested does not violate any of our treaty obligations. No provision of any treaty requires arm's-length pricing.

We suggest that the Treasury Department be required to report on the direction and anticipated timing of its efforts toward developing new substantive rules regarding the subjects addressed here. If sections 601-603 of the 1992 Foreign Tax Bill were enacted into law and Treasury were thereby required to file a study of section 482 with Congress by January 1, 1994, this could be included in that report.

C. New Source Rules

The United States should act unilaterally to adopt one set of new, substantive source rules, properly meshed with entity reallocation rules under section 482, for determining the portion of net income or loss from an international business transaction (or series of such transactions) that it will consider properly allocable to various countries having contact with a transaction.[85] It should do that instead of continuing its present practice of (i) providing no explicit source rule as a standard for exercise of the entity reallocation powers granted by section 482 for international transactions effected by a business through a controlled subsidiary or a commonly controlled affiliate, and (ii) providing explicit rules only for determining geographic source for an international business transaction effected directly by an enterprise or through an unincorporated branch[86] which are in conflict, or at least not coordinated, with results required indirectly under section 482.[87]

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[82]*See* discussion in the 1988 White Paper, *supra* note 14, at 36 and the cases described in that discussion.

[83]The proposed regulations recognize a profit split as a profit level indicator to be taken into account. They do so, however, only under limited circumstances and, unfortunately, still require resort to comparables to make the split. The proposed regulations in substance provide for a profit split circuitously through the construction of a comparable profit interval and a constructive operating profit. Though described as a means for determining an arm's-length price, it is merely a method of splitting a profit.

[84]*See* 1988 White Paper, *supra* note 14, at S-24.

[85]Section 203 of the 1992 Foreign Tax Bill, *supra* note 17, would do that in a limited context for U.S. tax purposes.

[86]In general, see IRC sections 861, 862, 863, 864, 865 for the existing source and related rules. Section 863(c)(1) provides specified source rules for transportation that begins or ends in the U.S. section 863(d) provides specified source rules for space and ocean activities. Section 863(e) provides specified source rules for international communications income. Section 865(e)(2)(A) treats as income from a United States source income from certain sales of personal property by a nonresident, including the sale of inventory "attributable" to an office or other fixed place of business within the United States. The latter is not applicable to sales of inventory which is sold for use, disposition or consumption outside the United States, if an office or fixed place of business of the taxpayer in a foreign country participated materially in the sale. *See also IRC section 864(c)(4)(B)(iii).*

[87]*See* the Examples earlier in the text beginning at notecall 54. *See also* IRC section 863(b) and Treas. Reg. section 1.863-3(b)(2), Example 1 and section 1.863-3T(b)(2), Example 2; IRC section 864(c)(3) ("force of attraction"), section 864(c)(4)(B) and (5), and Treas. Reg. section 1.864; and IRC section 865(e)(2)(A).

Recommended Criteria for New Source Rules[58]

The new substantive rules adopted by the United States for determining geographical source should relate to all types of income and expenditure entering into determination of net profit or loss. The new rules should provide operating rules to resolve difficult classification questions that frequently arise regarding the particular source rule that is to govern allocation of that item. The new rules should apply to fix geographical source both for purposes of a country's exercise of jurisdiction to tax on the basis of source and for its allowance of credit for another country's tax on income from sources in the other country. The new rules should allocate the combined net income (or loss) of the controlled group from each transaction with an independent third party by reference to a set of specific factors whose relative weights are specified and whose meanings are sufficiently clear to be reducible to numbers required on tax returns. The factors should call only for financial data that should be readily available to any properly managed business.

Unlike many of the existing U.S.-source rules, the new rules should focus not on legal formalities, but on the geographic locale of the business activities, assets, personnel, markets, and other factors that are actually involved in producing the business income or loss to be allocated. These criteria should prevent taxpayers—or taxing authorities—from fixing source by reference to arbitrary factors that lack economic reality and that are open to manipulation for tax purposes. Thus, we suggest that the factors so far as possible ignore legal formalities, such as place of passage of legal title to goods or place of incorporation or organization of a business, that are open to manipulation for tax purposes. The factors also should not include ones that are unlikely to be acceptable by other countries as a reciprocally applicable standard for geographic allocation of the international income tax base. In other words, the new rules also should have a realistic prospect for gaining international acceptance by other countries, especially those that are major trading partners of the United States. U.S.-source rules that fail to take account of major revenue and internal political interests of trading partner countries are likely to foster international conflict and double taxation and to be unstable due to their failure to do their job.

We do not suggest that Treasury, the IRS or the Congress await agreement by all other interested nations before acting legislatively or administratively to adopt new source rules. That would be unrealistic; the United States, like other countries, must have rules on such subjects to administer its tax laws pending international agreement. To the contrary, we suggest that the United States take the lead in acting unilaterally to modify its source rules and its section 482 rules to rid them of features that bear little or no relation to the geographic locale of the activities, assets, personnel, markets, and other economic realities involved in operation of an international business. It should do so, however, only in the light of past or future consultations with other nations in order to establish that the rules have a realistic prospect for acceptance by the other countries.

D. Multinational Agreement on Harmonized Source Rules

The United States should take the initiative to formulate and to secure multinational agreement to a single new set of definitive rules for geographically allocating income and loss to source. Preferably, this would be accomplished through a single, multilateral treaty to which agreement would be sought by all nations having significant international business transactions and that would enter into force with respect to each signatory country as it agrees. If no other route is feasible, however, this could be done through a network of bilateral tax treaties, or even through international executive agreements for implementing reciprocity as to source rules. The Treasury Department should pursue this objective

The U.S. should take the initiative to formulate and to secure multinational agreement to a single new set of definitive rules for geographically allocating income and loss to source. Preferably, this would be accomplished through a single, multilateral treaty.

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[58]We do not attempt here to state specific substantive terms for all the modified new source rules we recommend. We think that requires completion of a substantial amount of research work (especially on foreign laws and practices) and international consultation that has not yet been accomplished. Dale Wickham has begun work on a collaborative project looking to formulation of a draft international agreement that will provide proposed substantive rules for geographic allocations to source and procedural rules for resolving issues among countries that arise in interpretation and application to specific cases of the substantive sources and related rules concerning a party country's exercise of jurisdiction to tax international transactions. Lacking the product of the considerable work required in that project, we limit ourselves here to general criteria we recommend for modified new source rules.

by developing a new draft treaty after appropriate consultations with tax officials of our trading partners and through appropriate channels should request the OECD and the United Nations to initiate similar work.

Any model treaty and any multilateral or bilateral treaty should provide (i) for binding arbitration to resolve any disagreements between two competent authorities and (ii) for the publication of the arbitrator's decisions and reasoning. The treaty should also provide that a taxpayer requesting the assistance of competent authorities has the right to participate in the deliberations with the competent authorities of any other jurisdiction involved in the dispute. Members of the European Community have agreed to a convention that provides for binding arbitration.[89] The new income tax treaty between Germany and the United States provides for arbitration, but not for binding arbitration.[90] The decisions of some international tribunals or bodies are made public. That includes the decisions of the International Court of Justice and the decisions of the Iranian—United States Claims Commission. Sunshine can be therapeutic. It imposes a certain discipline on all concerned. It should not be shunned.

Any such treaty should also provide (i) that the decision, and the reasoning of the competent authorities in reaching their decisions be made public; and (ii) that any failure of the competent authorities to reach agreement be reflected in a document reflecting their respective points of view, their areas of agreement, if any, and their areas of disagreement. That document should be made public and would serve as information to the arbitrator responsible for deciding the issues. In the interim, existing treaties should be amended to provide for that course of action. Such decisions and reasoning should be made public in sanitized form to conceal identity and to protect trade secrets and other proprietary information. Technical advice memoranda, private letter rulings, general counsel memoranda, and revenue rulings are now made public in such sanitized form.

Our recommendation of a multinational agreement is certainly not new. It was made in December 1965, even before the then-proposed regulations were issued in 1966. It was made by the Treasury's Assistant Secretary for Tax Policy, Stanley Surrey, during whose tenure and under whose direction the existing regulations were issued. He recognized that "a unilateral approach by the United States, or any country, is not sufficient. For if our unilateral rules do not mesh with those of other countries the result will be double taxation, the tax burden of which will be borne either by one government through the foreign tax credit or by the taxpayer, with the other government obtaining an unwarranted benefit. (Far less likely, though possible, is undertaxation.) Each country, of course, must see both sides of the allocation coin. The rules which the United States regards as proper to allocate income to U.S. domiciliary companies from transactions with their foreign subsidiaries are the rules we must be willing to accept when the subsidiary is here and its parent is a foreign corporation. This factor should have an effect in tempering the international assertion of rigid positions, and thus make it easier to achieve international accommodation. It is clear that this must be the ultimate goal: an internationally acceptable set of rational rules to govern the allocation of international income arising through these transactions."[91]

> Our recommendation of a multinational agreement is certainly not new. It was made in 1965 by Stanley Surrey. He recognized that 'a unilateral approach by the United States, or any country, is not sufficient.... It is clear that this must be the ultimate goal: an internationally acceptable set of rational rules to govern the allocation of international income arising through these transactions.'

In August 1990, the United Kingdom, through its then Chancellor of the Exchequer and now Prime Minister John Major, invited the United States to join in seeking multilateral rather than unilateral solutions to problems of possible tax avoidance by multinational corporations; and not long afterward U.S. Treasury Secretary Brady an-

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[89]Section 3 of the "Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises." 33 *Official Journal of the European Communities* 19, L225/10 (90/463 OAK) (August 20, 1990). *See* in particular Articles 7 and 12 of section 3. All 12 member states of the EC signed it. Each must ratify it under its respective ratification procedures. Under Article 18, the convention will enter into force on the first day of the third month following that in which the instrument of ratification is deposited by the last signatory to ratify it. *See* John Turro, "EC Arbitration Treaty to Provide Solution to Transfer Pricing Disputes," 3 *Tax Notes International* 479 (May 1991).

[90]*See* Article 25(5) of that treaty. Convention for the Avoidance of Double Taxation. Aug. 29, 1989, Germany U.S., Art. 25(5), T.I.A.A., S. Treaty Doc. No. 101-10, 101st Cong., 2d Sess. (Feb. 5, 1990).

[91]*See* remarks of Stanley Surrey made in December 1965, quoted in Langbein, "Myth of Arm's Length," *supra* note 24, at 644.

nounced U.S. acceptance of that invitation from the United Kingdom as well as a similar invitation from representatives of West Germany.

We believe that the enormous amount of time and effort now devoted to implementing the APA and that will be necessary to attempt to collect the third party information necessary under the proposed regulations or on audit, in a continuation of a case-by-case approach would be better spent in reaching agreement with the tax authorities of other countries in a multilateral treaty on the geographic source of income, to thereby provide greater certainty, in advance, to all taxpayers and governments. The time and effort now devoted by the Service or Treasury personnel to persuading a given foreign tax authority to agree on a single APA applicable to a single taxpayer and members of its control group for a limited period of years could and should be directed instead to reaching agreement on source rules applicable to all taxpayers and to all governments involved.

The U.S. Treasury Department has the opportunity to take the initiative, to seek a multinational agreement on the geographic source of income. It should seize that opportunity. A unilateral approach will not suffice.

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FORM OF CITATION

Tax Notes International may be cited by reference to the volume number, publication name, page number, month, day, and year, thus: 4 *Tax Notes Int'l* 5 (January 6, 1992).

The International Tax Journal

VOLUME 18 NUMBER 1 • WINTER 1991

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A PANEL PUBLICATION

Editor's Note

This issue of *The International Tax Journal*, like international tax practice in general, is dominated by transfer pricing. In the first article, Dale Wickham analyzes the newly enacted penalty for transfer pricing valuation errors. He approaches the penalty from several directions, and concludes that it is inappropriate. He argues that the penalty is unnecessary in the few areas where the transfer pricing rules are clear, and that it penalizes conduct that lacks standards where the transfer pricing rules are unclear. Examining the transfer pricing penalty in light of the reasons for the recent reform in penalties generally, he argues that the transfer pricing penalty does not conform to the reasons for having penalties. He concludes that most of the problems of compliance in the area result from indefinite rules, rather than from lack of penalties, and suggests changes that can be implemented both administratively and legislatively.

The second transfer pricing article examines the major new development in that field: the ability of a taxpayer to seek a binding ruling on its transfer pricing methods. Karl Viehe, perennial chairperson of the IRS-George Washington University Tax Conference, analyzes the revenue procedure setting up the Advance Pricing Agreement (APA). He argues that the critical decision made by the IRS was to permit the taxpayer at the outset to have a conference with the IRS to discuss what will be necessary to secure a ruling. This permits the taxpayer to evaluate the costs and benefits of the ruling before deciding whether to proceed.

Robert Feinschreiber, our founding editor, rounds out this issue by calling our attention to a recent private letter ruling on foreign sales corporations (FSCs). While couched in innocuous terms, this ruling reminds us of Rufus Rhoades' dictum that FSCs are matters of accounting only, not creatures of substance. The letter ruling permits a taxpayer to change all manner of determinations after the close of the taxable year and after the initial return has been filed. This permits the taxpayer to adjust the balance between claiming FSC benefits and increasing the limitation on the foreign tax credit. The letter ruling also makes it much easier to satisfy the foreign economic activities requirements of having foreign trading gross receipts by liberalizing the transportation test and the credit risk test.

This is my last issue as editor-in-chief. Serving in that capacity has been a marvelous education, a great opportunity, and more work than I had ever imagined. It could not have been done without the editors at Panel

The New U.S. Transfer Pricing Tax Penalty: A Solution, or a Symptom of the Cause, of the International Transfer Pricing Puzzle?

Dale W. Wickham

Introduction and Perspective

An onerous new transfer pricing penalty was enacted by Congress as part of the Omnibus Budget Reconciliation Act of 1990 (the Act). This new penalty may be imposed at a rate as high as 40 percent of any understatement of U.S. income tax that is treated as being due to a "substantial valuation misstatement" of prices for transfers of property or services between members of a group controlled by the same interests.[1] The penalty is just one of at least seven new compliance measures in the Act relating to international transfer pricing.[2] Those were only the latest in a crescendo of policy-level actions over the last decade by the U.S. Congress, Treasury Department, and Internal Revenue Service (the Service) to deal with mounting problems in the area.[3]

This penalty is consistent with views expressed by certain Members of Congress during widely publicized hearings held in July 1990 by the Oversight Subcommittee of the U.S. House Committee on Ways and Means. Those hearings, which were on the general subject of possible underpayment of U.S. income taxes by U.S. subsidiaries of foreign companies,[4] focused largely on intercompany transfer pricing of "inbound" transactions; that is, the pricing of goods or services transferred to a U.S. subsidiary by a controlling or commonly controlled foreign corporation. There was testimony that in recent years these U.S. operations had underpaid their "proper" share of U.S. income taxes by as much as $50 billion by

reason of "improper" intercompany pricing. The general tenor of subcommittee views was expressed in one tax periodical's headline: "Ways and Means Panel Blasts Foreign Firms for Tax Dodging."[5] Even the Commissioner expressed his belief "that the U.S. government is being short-changed billions of dollars annually."[6]

Others contended, however, that it is impossible to find "abuse" or to estimate such U.S. revenue losses in this situation because there is such a wide range of defensible intercompany prices under the arm's-length standard.[7] Significantly, the Treasury spokesman, Assistant Secretary for Tax Policy Gideon, avoided characterizing the low income reported for U.S. tax purposes by foreign controlled U.S. subsidiaries as being due to "abusive" transfer pricing practices. He said he could not estimate the amount of any U.S. tax underpayments due to these companies' transfer pricing practices but he nevertheless concluded that reported data warrant careful scrutiny of the transfer pricing practices of foreign-controlled U.S. firms.[8]

These developments reveal the political genesis of the new transfer pricing penalty; they also reflect the growing problem of applying current regulations to international intercompany transactions. The current regulatory approach is not working.[9]

Tangible manifestations of the problem are elsewhere as well. There is the enormous dollar amount of tax, reportedly upwards of $25 billion, associated with international transfer pricing disputes pending before the U.S. Tax Court.[10] There also are greatly increased expenditures of money and manpower (including, now, those for "sole-source procurements" of economists and other expert consultants retained by the IRS) for stepped-up IRS enforcement activities in the area.[11]

The deadline of March 1, 1992 set for the Congressionally mandated study and report on this new penalty and other possible measures in the international transfer pricing area[12] indicates appropriate urgency. Accordingly, the question of what if any role the new transfer pricing penalty can play in the resolution of these problems should be disposed of promptly. This warrants consideration of whether spending some of our limited public and private resources for enforcement of and compliance with such a penalty is likely to be justified by bringing us nearer to a solution.

This article first examines the substantive terms and the origins of the new penalty. It then appraises the new penalty in terms of whether it is likely to contribute materially to solution of the mounting volume of high-stakes issues in multinational taxation of international business transactions, whether it is in keeping with principles that guided reform in 1989 of the U.S. civil tax penalty system, whether it was demonstrated to be a necessary addition to the penalties already available, and whether it was

an appropriate exercise of governmental authority. The article closes with a number of recommendations for actions by responsible governmental officials and representatives of international businesses.

The New Penalty and Its Origins

The new transfer pricing penalty is imposed[13] at a rate of 20 percent on that portion of an underpayment of tax[14] that is "attributable to" any "substantial valuation misstatement,"[15] and the rate is doubled to 40 percent where there is a "gross" valuation misstatement.[16] Subject to a *de minimis* limitation and an exception for reasonable cause and good faith, there is a "substantial valuation misstatement"[17] if either one of the following two very different conditions is present:

1. The price for any property or services (or for the use of property) claimed on any income tax return in connection with any transaction between members of a Section 482 control group is 200 percent or more, or 50 percent or less, of the amount ultimately determined under Section 482 to be the correct price;[18] or
2. The net effect for an entire taxable year of all adjustments under Section 482 in prices for property and services (the so-called "net Section 482 transfer price adjustment") is an increase in taxable income for the year of more than $10 millon.[19]

Such a "substantial valuation misstatement" becomes a "gross valuation misstatement" to which the 40 percent penalty rate applies if there is a doubling of the thresholds stated above. Thus, the rate in the first case above is doubled to 40 percent if the transfer price claimed by the taxpayer on its tax return is 400 percent or more, or 25 percent or less, of the price ultimately determined to be correct, or if, in the second case above, the net Section 482 adjustment for the year is more than $20 million.[20] The penalty has the effect of increasing the current 34 percent rate of regular U.S. corporate tax on income subject to the penalty to nearly 48 percent where the 40 percent penalty applies and to nearly 41 percent where the 20 percent penalty applies.

The "substantial deviation" basis for the penalty compares the tax return price and a price later ruled to be correct for a particular property (or service) in a particular transaction. Notwithstanding the statutory focus on one particular transaction, some netting of offsetting transactional adjustments within a taxable year may be allowable.[21]

The "net annual effect" basis for the penalty cumulates all transfer pricing adjustments for a taxable year. If the net amount of all pricing adjustments meets the $10 million threshold, liability for the penalty attaches without regard to how small the percentage of the price deviation

is for particular transactions; and the rate of the penalty for all transactions doubles if the pricing adjustments for a year rise to $20 million. Thus, a very low percentage change in unit price for a high-volume product or service may give rise to the penalty. Moreover, a penalty imposed on this net annual effect basis will loom larger in later years since the threshold amounts are not indexed for inflation.

Only transactions that are between persons covered by Section 482 are subject to the new penalty.[22] Thus, a transfer is not subject to the new penalty unless it is between persons "owned or controlled directly or indirectly by the same interests."[23] For this purpose, control is broadly defined as "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Control is not confined to cases of control through ownership of a certain prescribed percentage of the vote or value of outstanding securities.[24]

The new penalty applies only to adjustments made under Section 482 that are to the "price for any property or services (or for the use of property)."[25] The conference report states that "the conferees intend that the term 'price for any property or service (or for the use of property)' be broadly interpreted to encompass consideration of all kinds that may be adjusted by the IRS under Section 482, including but not limited to purchase prices, fees for services, royalties, interest, and rents."[26]

Can there be any adjustments under Section 482 that will not be treated as adjustments in the "price" of property or services? Can there be tax adjustments under Section 482 that are not "attributable to" a valuation misstatement? It seems clear that the answer to both these questions should be in the affirmative. Both the statute and the accompanying Congressional committee reports make it clear that the new penalty is intended to be restricted or "targeted" in its application so that it will apply the preexisting valuation misstatement penalty more effectively to situations involving valuation questions under Section 482.[27] Thus, where there is no dispute about the price or value of an item of property or service but there is about whether it generated, or was exchanged as consideration "for," an item of income, deduction, or credit, the adjustment should not be considered for purposes of this penalty to be "attributable to" a valuation misstatement of transfer "price."[28] The proper allocation among members of a controlled group is determined by resolution of the dispute.

The new penalty has been imposed and justified as an element of the substantial valuation overstatement component of the integrated accuracy-related penalty instituted in the 1989 reform of the civil tax penalty system.[29] As a result, the new penalty on transfer pricing misstatements is subject to standardized rules and limitations that apply to all the accuracy-related penalties. Thus, it is not "stacked" on top of (1) the penalty for

negligence or disregard of rules or regulations,[30] (2) the penalty for substantial understatement of income tax,[31] or (3) the penalty for civil fraud.[32] Similarly, the basic 20 percent rate for the new transfer pricing penalty is the same as that for the negligence and substantial understatement penalties. Further, the penalty is subject to a *de minimis* limitation, which prevents its imposition unless the portion of an underpayment for a taxable year attributable to Section 482 transfer pricing and other substantial valuation misstatements exceeds $10,000 for a corporation (other than an S corporation or a personal holding company) or $5,000 for other taxpayers.[33] Like the other accuracy-related penalties, the transfer pricing penalty does not apply if it is shown that there was reasonable cause for the taxpayer's price determination and that the taxpayer acted in good faith with respect to the price.[34] The penalty (1) is treated as an addition to the tax,[35] (2) bears deficiency interest,[36] and (3) is not deductible for income tax purposes.[37]

Significantly, however, relief from the new transfer pricing penalty is not automatic, as it is for substantial understatement of income tax not attributable to "tax shelter" items, to the extent that the understatement is attributable to the taxpayer's treatment of an item for which there is "substantial authority" or for which there was "adequate disclosure" of facts relevant to the item's treatment in the tax return or an attached statement.[38] Instead, the draftsmen partially analogized the treatment of the transfer pricing penalty to the less favorable treatment accorded to "tax shelter" items.[39] Moreover, relief is not even automatically granted by the statute, as it would be for a tax shelter, when the taxpayer reasonably believed that treatment of the item "was more likely than not proper."

Questions of whether the "reasonable cause/good faith" exception will be interpreted broadly enough to provide any part of the relief accorded under the "substantial authority," the "more likely than not proper," and the "adequate disclosure" exceptions remain to be answered. A proposed regulation released in March 1991 contains general statements that "[r]easonable cause and good faith is a facts and circumstances determination to be made on a case by case basis" and that in making that determination "the most important factor is the extent of the taxpayer's effort to assess the taxpayer's *proper* tax liability under the law."[40] However, the Service has stated that the proposed regulations are not applicable "in the context of transactions between persons described in Section 482 or net Section 482 transfer price adjustments," that they "do not consider how the reasonable cause exception should be applied" in such cases, and that it intends to begin asserting the new penalty without waiting for development of the further regulations it plans to publish regarding the new penalty.[41] Moreover, a Treasury Department official has stated that leaving to the courts

the job of developing the meaning of the reasonable cause/good faith exception may have "a useful *in terrorem* [] effect."[42]

The implications of these IRS and Treasury statements that the reasonable cause/good faith exception as applied to the transfer pricing valuation penalty may be given a different meaning and may require a different standard of taxpayer care than that for other components of the accuracy-related penalty find no support in the statute or the legislative history of the exception. Both the statute and the committee reports accompanying the legislation that reformed the tax penalty system in 1989 make it clear that the reasonable cause/good faith provision is intended to be a standardized exception applying uniformly to all components of the accuracy-related penalty for the sake of making taxpayer compliance and IRS administration of the consolidated accuracy penalties simpler and fairer. Thus:

> The bill provides special rules that apply to each of the [accuracy-related] penalties imposed under the new structure. First, the bill provides standardized exception criteria for all of these accuracy-related penalties. The bill provides that no penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayers acted in good faith. The enactment of this standardized exception criterion is designed to permit the courts to review the assertion of penalties under the same standards that apply in reviewing additional tax that the Internal Revenue Service asserts is due. By applying this unified exception criterion to all the accuracy-related penalties, the committee believes that taxpayers will more easily understand the standard of behavior that is required. The committee also believes that this unified exception criterion will simplify the administration of these penalties by the IRS.
>
> The committee is concerned that the present-law accuracy-related penalties (particularly the penalty for substantial understatements of tax liability) have been determined too routinely and automatically by the IRS. The committee expects that enactment of standardized exception criterion will lead the IRS to consider fully whether imposition of these penalties is appropriate before determining these penalties.
>
> The committee believes that providing greater scope for judicial review of IRS determinations of these penalties will lead to greater fairness of the penalty structure and minimize inappropriate determinations of these penalties.
>
> The committee intends that the terms "reasonable cause" and "good faith" be interpreted under the bill as those terms are interpreted under present law.[43]

The expressed intent of Congress was to consolidate, coordinate, and simplify penalty standards of taxpayer care and to improve compliance by providing a unified exception enabling taxpayers more easily to understand the standard of behavior required. The intent clearly was not to multiply standards or to leave the standard of care deliberately vague as under *in terrorem* approaches to tax compliance.

Clearly, the courts rather than the Service or the Treasury are expected to be the final arbiters on questions concerning the meaning to be given to the reasonable cause/good faith exception. They are expected to exercise their authority by building on the precedents of existing law. It is likely that the meaning given to the reasonable cause/good faith standard will be quite similar to the standard of compliance required for not being subject to the negligence penalty. Such an outcome would be entirely reasonable and arguably the best possible result from the standpoint of both the tax collector and taxpayers.[44]

The new penalty is effective for taxable years ending after the date of enactment of the Act,[45] which was November 7, 1990. By virtue of the draftsmen's deliberate choice of a taxable year ending, instead of beginning, after the date of enactment, the penalty is retroactively applicable to transfers made before enactment during a period which will be over 11 months long in the case of a fiscal taxable year ending November 30 and over ten months long for a calendar year.[46]

Origins of the New Penalty

The first public notice that the new penalty was being considered for enactment as part of the Budget Reconciliation Act of 1990 appeared on September 30, 1990, in a release by the Office of Management and Budget announcing the terms of the *Budget Summit Agreement* reached by Congressional and Administration negotiators after months of secret deliberations.[47] The penalty was among a group of seven foreign compliance, revenue-raising provisions in that agreement. Unlike the two foreign-controlled-corporation information-reporting provisions in the group, which were taken from a bill introduced by Chairman Rostenkowski and others for public study in March 1990, this penalty had not previously been made available for public study and comment.

The possibility of imposing penalties to ensure compliance in the transfer pricing area was raised by Chairman J. J. Pickle (D-Tex.) in a question to Assistant Treasury Secretary Gideon at the July 1990 hearings held by the House Oversight Subcommittee. Gideon expressed the view that additional penalties were not appropriate, indicating that the general thrust of the 1989 tax penalty reform was that such ad hoc addition of penalties does not work well. He noted correctly that penalties already available could be applied in appropriate factual situations.[48] Commissioner Goldberg, however, responded more positively to Congressmen's questions of whether additional sanctions were needed in the transfer pricing area, describing that as "a question worth looking at" and stating that "If there

are other ways to get at [the Section 482 transfer pricing problem] . .
no-fault penalties are a way to get at it, . . . I think we have to pursue i

Some senior tax officials in the Treasury and IRS National Office, one senior Congressional staff member serving at the time, have b careful to distance themselves from authorship of the new penalty an fix responsibility on Members of Congress; and some indicated that t were able to salvage the "reasonable cause/good faith" exception only a a valiant effort.[50] Nevertheless, there obviously were policy-level offic who acted on behalf of the administration to include the penalty in Budget Summit Agreement.

The new transfer pricing penalty ~~may~~ actually to have had its genes the Service or Treasury. Such a penalty was suggested in the Treasury White Paper on intercompany pricing released in October 1988.[51] White Paper stated, in particulars strikingly similar to those of the pen enacted, that:

> The Service and Treasury believe that taxpayer compliance in the transfer pricing area with respect both to disclosure of information and to conformity with the arm's length standard would be enhanced by the proper assertion of appropriate penalties . . . . Consideration should be given to when the section 6661 penalty [for substantial understatement of income tax] should be raised and whether it is adequate to deter instances where taxpayers do not make intercompany pricing decisions upon a reasonable basis, or whether a new penalty should be proposed.
>
> The Service and Treasury are interested in recommendations in this area, including such specific comments as to the type and amount of penalties, and whether there should be certain transaction oriented thresholds that ought to apply before any penalty could be asserted. For example, a transaction specific penalty (similar to the overvaluation penalty of section 6659) may be an appropriate means of deterring substantial deviations from the commensurate with income standard. Specific consideration should be given to whether the applicable penalty provisions should be amended to apply if there is a substantial deviation from the appropriate commensurate with income payment regardless of whether there is disclosure on the tax return of the manner in which taxpayers computed transfer prices. Disclosure of the taxpayer's method of computing a transfer price can not adequately inform the Service as to whether such a transfer price substantially deviates from the appropriate section 482 transfer price absent a thorough audit. Consequently, such disclosure should not prevent the imposition of a penalty for substantial deviation from the correct section 482 transfer price . . . .[52]
>
> The assertion of appropriate penalties is a necessary but often ignored element of transfer pricing compliance. In conjunction with the Service's broad-based review of penalties, the Government should determine whether existing penalties are sufficient to: (a) compel taxpayers to provide thorough and accurate information as set forth in paragraphs 2 and 3 *supra* [recommending that taxpayers be required to furnish on

> audit documentation of transfer pricing methodology used prior to filing tax returns]; and (b) deter taxpayers from setting overly aggressive and unjustified transfer prices that are inconsistent with the commensurate with income standard. If it is felt that existing penalties are inadequate, legislative solutions should be pursued. The Service and Treasury encourage comments in this area, including the type of penalty, such as a transaction based penalty, that might be proposed.[53]

Such suggestions for a "transaction specific valuation type penalty" as "an appropriate means of deterring substantial deviations from the commensurate with income standard" or from "the appropriate section 482 transfer price" are difficult to reconcile with conflicting conclusions elsewhere in the White Paper. Those include ones to the effect that in the case of high profit "intangibles it is difficult, if not impossible, to find comparables from which an arm's length transfer price can be derived,"[54] and others to the more general effect that "the regulations leave the Service, the taxpayers, and the courts with little guidance" where "no comparables can be found, or where similar items are only distantly comparable."[55] Remarkably, the White Paper makes no effort to reconcile the conflict between suggesting, on the one hand, a penalty for deviation from a standard and asserting, on the other hand, that the standard does not exist.

Appraisal of the New Penalty

Is the new penalty likely to contribute to solving the growing international transfer pricing puzzle? Is it a necessary addition to those already available? Is it founded on reasonably clear principles, fair to those upon whom it is levied, and likely to be a cost-effective use of limited public resources? Is it an appropriate use of the U.S. tax penalty system as recently reformed? Is it an appropriate exercise of governmental authority?

In the view of this observer, the answer to each of these questions must be in the negative.

Will the New Penalty Contribute to Solving the International Transfer Pricing Puzzle?

Cases where the Section 482 regulations do not furnish sufficient transfer pricing guidance: The new penalty is founded on a number of premises about the nature of the problem that are mistaken and make it highly unlikely that it will contribute to solving international intercompany transfer pricing problems.

Some of the mistaken major premises include the following:

- There is a price that is "right" under the law for any transfer or other transaction subject to Section 482

- The "right" price is ascertainable by the taxpayer before the transaction must be consummated
- If there is a significant deviation between the price used on the tax return and the price ultimately determined by the Service or the courts to be right, the deviation should be presumed to be due to some "abuse" or fault on the part of the taxpayer[56]
- The precision with which a taxpayer is capable of determining the right transfer price (or a right allocation of profit-related items) increases with increases in the dollar volume of Section 482 transactions to such an extent that large volume alone should cause a taxpayer to be held presumptively liable for penalty on deviations that, no matter how small individually, produce a net Section 482 adjustment in excess of $10 million a year.

Actually, the problem at the core of the international transfer pricing puzzle is a lack of rules of law for determining what transfer price is right, or what allocation is right for items of revenue, expense, profit, or loss that are involved. At present there is not even agreement about what methods should be permitted for these purposes, let alone agreement on the kinds of rules needed to determine the legally correct price or allocation of profit-related items in a specific case. That is the government's failure, not the taxpayers'. No amount of governmental action taken in anger or frustration to penalize business taxpayers, to compel reporting of more information, or to step up tax enforcement efforts can be a substitute for governmental action that forthrightly addresses the problem.[57] Only by promulgating rules of law will clear answers be given to the questions: What price is right? What allocation is right?

Section 482 speaks with a dramatic sweep of the legislative pen that is more remarkable for its generality, brevity, and breadth of delegation of power than for its specificity or clarity. Thus, Section 482 now provides in its first sentence, essentially as it has since 1928, that:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The author is not aware of any commentator having seriously contended that the quoted statutory language determines price in any particular case. Indeed, the wording of the statutory standard—whether an allocation by

the Service is necessary (1) "to prevent evasion of taxes" or (2) "clearly to reflect income"—so lacks specificity that there is neither reference to nor requirement for the "arms-length" standard adopted in the regulations.[58]

Much the same is true of the arm's-length standard of the regulations.[59] Though wordier, the regulations are viewed, even by the authors of the Treasury/IRS White Paper, as depending for their meaning and workability on the presence of comparables that in practice generally—but not always—are unavailable. Similarly, the judicial decisions depend heavily on their facts. They yield few generalizable principles of law that can resolve specific cases, even cases for later years between the same parties.

The absence of rules of law for determining what transfer price is correct was accepted as fact and described at length in the Treasury/IRS White Paper in terms that are highly relevant to appraisal of the new penalty:

> In general, the section 482 regulations relating to services, intangible property, and tangible property rely heavily on finding comparable transactions. The regulations provide little guidance for determining transfer prices in the absence of comparables.[60]
>
> . . . [T]he section 482 regulations rely heavily on finding comparable goods, services, and intangibles to determine whether an arm's length price has been used. Where such comparables exist—where arm's length transactions bearing a reasonable economic resemblance to those being examined have occurred in the free market—application of the regulations is relatively straightforward. Where no comparables can be found, or where similar items are only distantly comparable, the regulations leave the Service, the taxpayers, and the courts with little guidance.
>
> . . . .These [recent] cases [regarding use of comparables in the context of sales of tangible property, the provision of services, or transfers of intangible property] show that comparables are often difficult to locate, and may be misused or misinterpreted even if they are found. In most of the cases discussed in this chapter, no comparables were available.[61]
>
> . . . [B]ecause of the extraordinary range of returns earned at arm's length, even within a single industry or company, no principled and equitable basis for such safe harbors could be devised.[62]
>
> Because . . . [high profit] intangibles are so often unique and are typically not licensed to unrelated parties, it is difficult, if not impossible, to find comparables from which an arm's length transfer price can be derived.[63]
>
> One of the most consistent criticisms of the section 482 regulations is that they do not provide taxpayers with enough certainty to establish intercompany prices that will satisfy the Service without overpaying taxes. Based on the government's experience in litigation, the current section 482 regulations also fail to provide the Service and the courts with sufficiently precise rules to make appropriate section 482 adjustments, especially when third party comparables are not available. . . .[64]

What price is right for an international transfer among enterprises under common control? The difficulties posed by this question are essentially

like those posed by the question, "What price is right for dealings with one's self?" What indeed is the "right price" for a vendor's transfer of apples from one bin to another in his store? From one to another of several stores he owns? From the grower's orchard to his trucks? From the vendor's trucks to his storage facility? From his storage facility to his market? Is the answer the same if one of the stores is in Canada and another is in the United States? Is the answer the same whether the tax authority setting the appropriate transfer price is Canadian or U.S.?

Several difficulties are posed by these questions if they are put for purposes of exacting an income tax on each of these transfers and if each transfer, instead of being between unincorporated branches of one corporate enterprise, is between separately incorporated but wholly owned units of the same corporate enterprise, all of the stock of which is owned by the vendor. First, because the vendor really is just dealing with himself and has no need to price the apples on the occasion of any of these transfers, neither he nor the tax collector has any real price set by external market forces to use in trying to compute an income tax on these self-dealing intercompany transfers. Lacking a market price, efforts can be made to "construct" a hypothetical or "deemed" transfer price. It should come as no surprise, however, that the price thus "constructed" will be just that—not real. That the price will be "constructed" and not real will be due not to taxpayer "manipulation" or "abuse" but to the choice of policymakers to make liability for income tax turn on acts of self dealing for which there are no "real" prices. The lengths to which the existing regulatory regime carries the insistence on establishing a hypothetical price is shown by those rules authorizing allocations and prices to create income where none is actually realized.[65]

To construct a hypothetical price for the vendor's transfer of his apples, the tax collector and he may make a search for "comparable" prices for transactions at "comparable" times that arise in "comparable circumstances" but from arm's-length transactions, either between the taxpayer and other persons not under common control or between other persons who are unrelated to the taxpayer and not under common control. Whether a search for such "comparable" prices is even conceptually correct is a question appropriately raised by many.[66] Whether it is or not, that is what the existing Treasury regulations compel.

If the search for comparable arm's-length prices is often fruitless, how will the vendor and the tax collector "construct" hypothetical prices for the apples? That is the dilemma of the existing Treasury regulations. Those regulations give no answer to the question of what method should be used to determine the "right" hypothetical price when there are no comparables available for the methods they prescribe. Neither do they generally answer

questions about what methods should be used to allocate profit-related items among various countries and various entities within the control group to construct the "right" or "true" hypothetical taxable income. Whatever the tax collector and the vendor do to resolve this dilemma posed to them by the Treasury regulation, one can be sure that the transfer "prices" they come up with will be "constructed," not real prices.

In most international transfer pricing cases, the task clearly entails far more than searching for comparables. It requires answering a multitude of complex questions and it requires deciding how to allocate the worldwide revenues, expenses and other items that enter into calculation of tax profit or loss among the various countries and entities within a control group. For example, what are the business benefits that really were received by business Y in a transfer from business X? Did Y receive only tangible property, such as merchandise inventory manufactured or partially processed by X, or the use of X's productive plant or equipment? Did Y receive both tangible property and the benefits of use of intangible properties, such as X's good trade name, X's patents or trademarks or secret processes? Did Y receive services provided by X, such as technical services for product manufacturing, marketing or servicing, for product development or improvement, or for general administrative support? Did Y receive cash capital, and if so, was it borrowed or equity capital? Did Y receive a package including a combination of property, services, and capital? Were there cross transfers to X by Y of offsetting business benefits, and what exactly were those? Then, having answered such questions about what was transferred by each business to the other, what is the "right" price for each item transferred, at the times and under the circumstances actually involved? What other prices for what other transactions, if any, are "really" comparable, and are they "exactly" comparable or only partially comparable, requiring "adjustments" of uncertain scope to bridge the gap? If there are no comparables, what should be done then? What portion of the revenue items of the combined enterprises should be allocated to which individual members of the controlled group? What portion of the expenditure items should be allocated to what categories of income and to which individual members of the group? What portion of each item of income and expense should be allocated geographically to sources within the United States and to sources within each foreign country or countries involved? Such allocation questions frequently are complex, lack clear-cut answers under the law, and are commonly answered very differently by tax authorities of the different countries involved. Furthermore, to the extent that the countries seeking to tax the enterprise's income from international transactions do not resolve differences on how to harmonize their taxes, members

of the enterprise may be exposed to double or multiple international taxation of their income.

It should be evident that it was specious for proponents of the new penalty to have analogized complex international, intercompany transfer pricing cases to cases involving fungible, "off-the-shelf" commodities for which there are well established markets. Insisting that there generally is a "right" arm's-length price to be found for intercompany transfers is insisting on an illusion. No such insistence and no amount of penalizing or interrogation of a taxpayer can produce that which does not exist: clear rules.

In essence, the current Treasury regulation under Section 482 is often compelling the taxpayer, the tax collector, and the courts to search for something that does not exist. That is one of the main reasons why the courts, the tax collectors, and the taxpayers are having so much difficulty resolving differences about how to bring Section 482 cases to a conclusion is that: they are given rules to follow that do not work, which lead them down dead-end streets, which require hypothetical questions for which there are either no definitive answers or many possible answers but no obvious criteria for selecting one over another, and which leave them without principled rules of law to follow to resolve their differences. The only wonder is that afflicted taxpayers and tax collectors alike have not arisen to change the law.

Alternative approaches: Although their description and evaluation is beyond the scope of this article, there are a number of promising alternatives to the current regulations which merit serious consideration.[67] The real issue is which ones are likeliest to reduce the enormous problems being generated by the current regulatory regime in a fashion that will satisfy the major requirements for a workable system of law in this area. The task of identifying, developing, evaluating, testing, and securing the governmental and public consensus required to implement an improved system is a large and difficult one that cannot, and ought not, be accomplished overnight. Nonetheless, a conviction that there are in fact feasible alternatives for doing the job much better, combined with determined leadership on the part of the Treasury Department and cooperation and support from the governments of our major trading partners and responsible leaders of international business, could produce major, international achievements.

Cases where the Section 482 regulations furnish some transfer pricing guidance: Significantly, those cases for which the standards prescribed under the existing Section 482 regulations furnish all the guidance needed are not the ones presenting the problem of substantial deviation of the taxpayer's transfer price from a preconceived norm. Because the standard

is clearly prescribed and ascertainable in advance, prices set by the taxpayer are more likely to conform. Where price does deviate substantially from the norm, there is nothing peculiar to the problem that cannot be satisfactorily addressed by the other civil and criminal tax penalties available. Cases in this category include ones where only valuation issues are involved and where there are exact comparables for which the "comparable uncontrolled price" method preferred by the regulation furnishes sufficient valuation guidance. These cases *may* include:

- Intercompany loans where the safe harbor interest rate for the loan transfer is readily ascertainable;
- Rental of realty or large tangible items where comparables are easily ascertainable;
- Rendition of commonplace services where cost is the measure; and
- Situations where either the resale price method or the cost-plus method (as prescribed in detail in the regulations) can be used and where there is relative agreement on which industry the goods are appropriate to and where there is a stable rate of return across that industry.

It should be clearly understood, however, that the cases just described are not properly includable in the category for which the regulations furnish sufficient guidance if, as is frequently the case, issues other than valuation issues are present. Moreover, even where only valuation issues are present, the "comparables" available for use with the resale price method and the cost-plus method frequently are not really comparable. One expert economic consultant in the area, Dr. Emil Sunley, has stated that his experience with cases in which the resale price or the cost-plus method are used is that "comparable" sales by a taxpayer are nearly always into a different market and that "comparable" sales by third parties generally involve different products. Clarification of the expected standard for transfer prices is much more likely to reduce substantial deviations in taxpayers' prices, and other penalties available are sufficient for these cases.[13]

Is the New Penalty a Necessary Addition to Those Already Available?

Enactment of the new transfer pricing penalty was justified in accompanying Congressional materials exclusively in terms of what it would do to remove "difficulties" in applying the existing valuation overstatement penalty in Section 482 cases. Nothing was said about whether the other penalties available were adequate to meet those difficulties. For example, an official explanation added to the legislation reported by the House Committee on Ways and Means states that the valuation overstatement penalty was amended to eliminate three difficulties: namely, that it did

not apply where (1) the value reported for the transfer deviated by less than the required 200 percent but millions of dollars of tax were involved, (2) the valuation misstatement related to services rather than property, and (3) the Section 482 adjustment was attributable to an undervaluation.[68] There are no such difficulties, however, with the negligence or substantial understatement penalties.

An examination of the tax penalties available for use in transfer pricing cases when the new penalty was enacted shows that those included one or more penalties capable of dealing with all the problems discussed at the July 1990 House Oversight Subcommittee hearings. Evidence in the limited public record offers no support for the view that compliance problems would be improved by adding the new penalty to the veritable arsenal of civil and criminal tax penalties already available.[69] To the contrary, it shows that proponents of the new penalty made no effort to carry their burden of demonstrating why a new penalty should be added, as was expected under the principles that guided reform of the penalty system in 1989. It also supplies strong evidence that other measures, notably promulgation of new substantive rules clarifying what transfer prices or what geographical allocations of profit related items are correct, are more likely to improve compliance.

The Other Penalties Available: The civil tax penalties available include:

1. The following three accuracy-related penalties:
   (a) the penalty for negligence or disregard of rules or regulations;[70]
   (b) the penalty for substantial understatement of income tax;[71]
   (c) the penalty for substantial valuation overstatement for income tax purposes;[72]
2. The fraud penalty;[73]
3. The far-reaching penalties, enacted in 1989 and 1990 and aimed particularly at transfer pricing, for failure of a 25 percent foreign-owned domestic or foreign corporation to report such information or to maintain such records and to comply with such U.S. corporate-agent designation requirements as the Service by regulations may require in respect to transactions between the reporting corporation and related parties[74] or any transactions of any foreign corporation doing business in the United States (whether or not foreign owned);[75]
4. The general penalties for failure to comply with tax-related information reporting requirements;[76] and
5. The third-party penalties for aiding and abetting understatement of tax liability[77] and for understatement of a taxpayer's liability for tax by an income tax return preparer.[78]

The criminal tax penalties available include:

1. The felony penalty for willful attempt to evade or defeat tax (the so called "tax evasion" or "tax fraud" penalty);[79]
2. The misdemeanor penalty for willful failure to file a return timely or to supply information or to pay tax;[80]
3. The felony penalties for making, or assisting in the making of, fraudulent and false tax returns, statements, or documents;[81] and
4. The penalty for attempts to interfere by force or threats of force with an official in his or her administration of U.S. tax laws.[82]

The penalties just described include at least one, and often more than one, for dealing with improper or "unduly aggressive" transfer pricing practices of the kinds about which Congressmen expressed concern. Most of these were cases where the taxpayers made "no reasonable attempt to comply with the law" or where the taxpayer exhibited a "careless, reckless, or intentional disregard of rules or regulations." All such cases are clearly covered by the basic and long-standing civil penalty for negligence or disregard of rules or regulations. They will also be covered on some facts by the no-fault civil penalties for substantial understatement or for valuation overstatement. They will be covered by either the civil or the criminal penalties for fraud if there is the requisite evidence of actual, intentional wrong-doing and the intent is the specific purpose to evade a tax believed owing. Moreover, any continued failure by a taxpayer to furnish such information or to maintain such records as the Service might require, either under Sections 6038, 6038A, or 6038C, would expose the taxpayer not only to the monetary penalties provided for noncompliance but also to the loss of deductions or cost-of-goods-sold allowances that the Service is empowered by Section 6038A to disallow for transfers between related parties, or to the loss of foreign tax credits that the Service is empowered by Section 6038 to disallow.

The Evidence on the Record: A review of the July 1990 public hearings held by the House Ways and Means Oversight Subcommittee reveals that no witness recommended adoption of a new transfer pricing valuation penalty. To the contrary, the spokesman for the Treasury Department, Assistant Secretary Gideon, recommended against such penalties, declaring flatly that "I don't think additional penalties are appropriate at this time."[83] Secretary Gideon then added:

> Remember, this subcommittee did a substantial revision of the penalty structure last year and the general thrust of that was that adding all kinds of ad hoc penalties really didn't work very well
>
> On the other hand, there may well be cases where the facts suggest that application of the general penalties we have now may be appropriate.

> *Chairman PICKLE.* Can you tell me why we have had no penalties assessed?
>
> *Mr GIDEON.* In the transfer pricing area, I think it is really difficult to do that unless you could find a flagrant case.
>
> Usually these cases are quite fact intensive, as a result there are reasonable points of view on the other side and when that happens you typically don't get penalties.[84]

Subcommittee members were aware that a number of civil and criminal tax penalties (including the penalty for substantial understatement,[85] penalties against civil tax return preparers,[86] and penalties for civil and criminal tax fraud[87]) were available for use as needed to help increase compliance in the transfer pricing area, and that the Service had been asserting the substantial understatement penalty in some transfer pricing cases.[88] However, subcommittee members were repeatedly cautioned by IRS witnesses against expecting penalty enforcement efforts to produce much improvement in compliance in transfer pricing, primarily because of the great difficulty the Service has in even establishing that the taxpayer's pricing was wrong.[89] Commissioner Goldberg, for example, testified as follows in response to questions from Former Congressman Flippo (D. Ala.) about why, in transfer pricing cases, there had not been more vigorous and successful assertion of tax penalties, especially the understatement penalty:

> *Mr. FLIPPO.* We have a situation in which you have the authority to assess the penalties for substantial understatement. There is clearly substantial understatement, and yet no penalties have been successfully applied. And that is what I am trying to understand, is why—
>
> *Mr. GOLDBERG.* I appreciate and understand your concern. I ought to point out, as you have heard publicly and in executive session, these are extremely difficult cases to make. There are cases where our pricing turns out to be as wrong as the taxpayer's pricing. If we say it is $10 and they say $20 and the court comes in at $15 we are half wrong.[90]

The essence of witnesses' advice to the subcommittee was that compliance measures other than penalties should be given priority. The other compliance measures recommended were of three kinds: (1) new information reporting requirements, to be prescribed legislatively in some cases and administratively in others, (2) heightened audit activity, and (3) new substantive rules of law, clarifying for taxpayers and tax administrators alike the rules and methods for determining transfer prices or allocations that will be accepted as correct when used in preparation of tax returns. Treasury Secretary Gideon and Commissioner Goldberg, while not ruling out the need for new substantive rules, assigned top priority to implementing new information reporting and to stepping up audit activity.[91] Other witnesses, however, emphasized the need for new substantive rules to

determine transfer prices for tax purposes.[92] An experienced former IRS international examiner in Los Angeles, Frances Zuniga, stated:

> At the heart of the problem is Section 482 and the regulations. No one knows what arm's-length means. This is especially true because there are simply no comparable transactions for many of these companies. The arm's-length standard exists in a world of smoke and mirrors. The arm's-length standard pretends that related companies behave as if they are unrelated, and assumes that in each marketplace there are willing buyers and sellers. This assumption clearly does not work where the market is controlled. The three pricing methods specified under the Regulations; the CUP method, the Resale Price method and the Cost Plus method, clearly cannot apply to the foreign controlled distributor.
>
> Therefore, under these circumstances, the IRS is left with using "any reasonable" method to determine the arm's-length standard, or price. This is known as the 4th method. The Regulations give almost no guidance on using the 4th method, despite the growing dependence on it. Instead of providing flexibility to the IRS, the result becomes chaotic, again because no one knows or can agree on what exactly is an arm's-length standard.[93]

Is the New Penalty an Appropriate Use of the Tax Penalty System and Consonant With the Principles That Guided its Recent Reform?

Is the new transfer pricing penalty consistent with the principles that guided the reform of the civil tax penalty system accomplished just a year earlier in 1989? Significantly, that question is not even addressed in the Congressional committee reports accompanying the legislation that imposes the new penalty. That may be due in part to the nature of the legislative procedure followed. The legislation was developed and drafted in secrecy and enacted hastily after summaries were first exposed to public view on September 30, 1990, just 35 days before the President signed the legislation into law. Unlike other foreign compliance provisions included in the 1990 Budget Reconciliation Act, this penalty was enacted without having been first introduced in the form of a bill and made the subject of a public hearing affording the public an opportunity for comment on the policy and structural details of the elaborate new penalty structure proposed. Whatever the cause, the new penalty contravenes many of the key principles that guided the 1989 reform.

When evaluated against a checklist of principles as to what a tax penalty should and should not be, taken from the Service's 1989 *Report on Civil Tax Penalties*,[94] the *Penalties Study Report* of the Section of Taxation of the American Bar Association,[95] and other materials considered in the 1989 reform, the new penalty on transfer pricing does not score well, violating nearly every principle on the list:

1. *Principle: A penalty should not be retroactive.*[96] The new penalty is retroactive, bearing an effective date that causes it to apply to transfers that may have occurred as much as 11 months before its enactment. Violation of the principle that a tax penalty should not be retroactive is especially objectionable in the case of a transaction-specific penalty such as this, which can only be justified as reinforcing a normative standard for taxpayer conduct in ways that will deter or encourage taxpayer activities which shape the contractual terms of business arrangements under which a transfer is to be consummated.

2. *Principle: A penalty should not be used to raise revenue.*[97] The new penalty was viewed by the 1990 Budget Summit conferees and the Congress as a revenue-raising provision. It was classified as such in the Budget Summit Agreement[98] and in ensuing Congressional committee reports.[99] Interestingly, the amount of additional revenue anticipated is not disclosed in Congressional committee reports or other materials accompanying the 1990 Budget Reconciliation Act. The extraordinary uncertainties associated with determining the revenues that would be raised through enforcement of Section 482 without regard to the new penalty, combined with uncertainties about the meaning of the new penalty provisions, their relation to other penalties already available, and what changes in taxpayers behavior should be assumed to result from its enactment, suggest that any such estimate of revenue effect of the new penalty would only be meaningless speculation.

3. *Principle: A penalty should reinforce and be rationally related to a standard of behavior that exists in the law and that is stated clearly in terms that are comprehensible to the taxpayer.*[100] The new penalty is signally deficient under this principle. Treasury and IRS personnel developed this point at length in the White Paper. The absence of rules for determining what transfer price is correct and what intercompany and geographical allocations of profit-related items are correct are the central problems in Section 482. As the White Paper stated:

> Based on the government's experience in litigation, the current section 482 regulations also fail to provide the Service and the Courts with sufficiently precise rules to make appropriate section 482 adjustments . . . .[101]

That clearly does not meet the standard set forth in the Commissioner's *Report on Civil Penalties*, which states:

> To self-assess one's tax liability and voluntarily pay it, a taxpayer must know the rules that he or she should follow in assessing and paying the liability. As a practical matter, this requires written materials providing an explanation of the rules and forms that permit the self-computation of tax liability.[102]

4. *Principle: A penalty should be effective.*[103] The new penalty's effectiveness in improving voluntary taxpayer compliance is bound to be undermined by the present lack of rules of law for determining in any specific case what transfer price is right and what intercompany and geographical allocations of profit-related items are correct. Moreover, as the Service recognized in its *Report on Civil Penalties*, effectiveness of the penalty may be undercut by its severity. Imposition of a penalty as severe as this can make the stakes so high that a taxpayer is more likely to litigate—or to settle in a proceeding not guided by principles of law because the taxpayer feels threatened. As the Service stated, "increasing severity in a way that is unrelated to this deterrence objective is inappropriate and unnecessary".[104]

Experience in litigation and administrative proceedings involving valuation or other issues under Section 482 and in other areas of the law where there are no legal standards or only vague ones about what is "right" argue for being very cautious in accepting facile assertions that existence of the new transfer pricing penalty will induce taxpayers to take less extreme positions. Experience of many suggests precisely the opposite. The prospect that an IRS examining agent having a different view about price may increase any tax deficiency he proposes by simply asserting a 20 percent or 40 percent penalty could well lead a taxpayer rationally to conclude that initially claiming a more aggressive value serves his or her interests better in the long run, because some court or other authority arbitrating the dispute may simply "split the difference." IRS Deputy Associate Chief Counsel (International) Charles S. Triplett stated:

> In what may have been efforts to achieve judicial economy, many cases have resulted in decisions that represent a compromise of the position of the parties. An unfortunate byproduct of these cases is that they may very well influence both the government and the taxpayer to press overly aggressive positions, on the assumption that the court is going to scale back anything either side proposes.[105]

5. *Principle: A penalty should be fair, and should be perceived to be fair.*[106] The new penalty is grossly unfair. It holds a taxpayer presumptively liable by reference to a legal standard that was not in existence at the time the taxpayer shaped and completed the business transaction to be reported later on a tax return.[107] The taxpayer is penalized by reference to a standard established only after the behavior. If the penalty were "criminal," such a law would be unconstitutionally *ex post facto*. Similarly, a criminal law would be subject to constitutional challenge for undue vagueness. Should the labelling of a tax penalty as "civil" rather than "criminal" make such a difference in its desirability or its constitutionality?

6. *Principle: The amount of a penalty should be perceived to be fair and reasonable and not disproportionate to the culpability of the conduct in*

question.[108] The new penalty, through use of an automatic, "objective" standard for measuring the size of a Section 482 pricing adjustment, holds a taxpayer presumptively liable for the penalty, at a very high rate, without any requirement that he or she be shown to be at fault. Instead, it indiscriminately places on all taxpayers the burden of proving that they had reasonable cause and good faith for intercompany transfer prices reported on their tax returns. It does so deliberately under the "net annual effect" basis, even though the deviation of the price used on the tax return from the price ultimately held to be correct is small or clearly within the 200 percent/50 percent standard set under the new law as being acceptable. This expresses a view that an international business should be subject to the penalty just because it happens to be large.

In its 1989 *Report on Civil Tax Penalties*, the Service stated:

> If penalties become too severe, they may have penal aspects, penal aspects that are more appropriately dealt with in the context of criminal sanctions. . . .
>
> If the severity of a civil penalty exceeds the severity that is appropriate in a civil context, it may have an adverse impact on taxpayer attitudes about the fairness of our self-assessment system.[109]

Notwithstanding such principles, unless the "reasonable cause/good faith" exception applies, the new transfer pricing penalty may be imposed at the rate of 40 percent in cases argumentatively labelled as "gross valuation misstatements," even though the taxpayer was not "negligent" within the meaning of the accuracy-related penalty provisions of the law. If the taxpayer were actually negligent, i.e., had failed "to make a reasonable attempt to comply with" the law or had acted in a way that was "careless, reckless," or in "intentional disregard" of rules and regulations, the penalty would only be at the 20-percent rate.[110]

Moreover, the statute deliberately withholds other forms of relief granted to taxpayers for other accuracy-related penalties. The taxpayer is not automatically granted relief from the new penalty because he can show he had "substantial authority" for his position, because he made "adequate disclosure" of all the relevant facts because he believed that the transaction as reported on his tax return was "more likely than not proper," or because for there was "no intent or plan to avoid tax." Relief will be available in such cases only to the uncertain extent the taxpayer can show it is warranted by the "reasonable cause/good faith" exception.

These new rules will almost certainly be viewed as punitive, severe, and unrelated to culpability. It seems highly unlikely that the authors of the new penalty expected the rules to be perceived as fair and proportionate to culpability; it seems much more likely that the authors consciously decided to depart from principles of fairness and proportionality in favor of being

tough" where the taxpayer involved is a large and politically vulnerable international business that is a potential source of revenue.

7. Principle: A penalty should be readily administrable in the sense (a) that it will be imposed when it should be and not imposed when it should not be, (b) that it not be so excessively severe as to make it difficult to impose, and (c) that demands made by its enforcement on the limited resources of the Service will not divert those resources from more important objects.[111] The new penalty casts a large net, sweeping up many taxpayers who have engaged in no misconduct. Its automatic presumptions permit relief from the penalty only by a finding that the specific pricing actions of the taxpayer challenged by the Service were taken with "reasonable cause" and "in good faith." Such a finding requires "a facts-and-circumstances determination to be made on a case-by-case basis,"[112] separate from the one the Service must make to challenge the taxpayer's transfer price. Each such determination requires a factual investigation and legal evaluation necessarily make significant demands on the limited resources of the Service. Nevertheless, the resources must be expended if innocent taxpayers initially caught in the broad, tight net of the penalty's presumptions are not to be penalized, too.

The new transactional-specific transfer pricing penalty does not comport with the principle stated in the Service's *Report on Penalties*:

> . . .[T]he design of penalties should follow a course that recognizes the limited resources for administration of penalties. Specifically targeted penalties aimed at marginal noncompliance, elegantly structured but difficult-to-administer penalties, and legislative or regulatory demands for scarce resources in particular areas that prevent the broader consideration of competing resource needs should be avoided.[113]

The new penalty aggravates the costly habit of diverting limited public and private resources and energies into directions that do not focus on developing substantive rules for principled disposition of issues lying at the core of the problems presented. This is a drawback that the new penalty shares with the multitude of recent initiatives for stepped-up enforcement, for information reporting, and for dispute resolution, which attempt to deal with problems in this area on an ad hoc, case-by-case basis. Though some such initiatives are promising, they cannot substitute for substantive and more generally applicable rules that resolve the issues on a more principled and predictable basis.

Comparison of the New Penalty to the Negligence Penalty

The key respects in which the new penalty fails to conform to the principles that guided the 1989 reform of the civil tax penalty system may

be seen more clearly by comparing the new penalty to the negligence penalty.

The negligence penalty applies only if (1) there is in existence a substantive rule or regulation that clearly states in advance the behavior expected of a taxpayer, and (2) the taxpayer's behavior in disregard of the rule or regulation meets the statutorily stated standard of (a) being intentional, reckless, or careless, and (b) not being under the circumstances a reasonable and good faith effort to ascertain and to comply with the rule; and if it applies, the amount of the penalty is computed by reference only to that part of any understatement of tax that is attributable to the taxpayer's negligent behavior.

The structure of the negligence penalty—unlike that of the new transfer pricing valuation penalty—reinforces the duty of governmental tax authorities to make substantive rules that define in advance and in understandable language the behavior expected of taxpayers; and if they fail to discharge that duty, there is no penalty. The structure of the negligence penalty also reinforces the reciprocal duty of all taxpayers to make reasonable and good faith efforts to find out and comply with what is expected of them under those rules; and if they fail to discharge that duty by disregarding those rules, they will be subject to a penalty at a substantial 20 percent rate on any part of a tax understatement due to their negligent conduct.

The negligence penalty, unlike the new transfer pricing valuation penalty, scores well under the major criteria for a tax penalty described above: It meets the cardinal criterion of being designed primarily to reinforce a substantive tax rule or "normative standard" for taxpayer behavior rather than to raise revenue or achieve some other purpose. It can be effective in that it is imposed at the substantial but not unduly severe rate of 20 percent that is targeted to that part of an understatement of tax due to a taxpayer's misconduct. It is fair in the sense that it treats similarly situated taxpayers similarly; it does this both in reference to the substantive rule of tax law involved and in reference to the procedural standard of care as to whether a reasonable and good faith effort has been made by a taxpayer to comply with the substantive rule. It also is fair in the sense that the rules by reference to which it operates, both substantive and procedural, must have been promulgated in advance of the conduct subject to the penalty.

Is the New Penalty an Appropriate Exercise of Governmental Authority?

The decision to add the new transfer pricing valuation penalty to the vast arsenal of penalties and other loosely constrained powers already accorded the Service for interpreting and enforcing the vague standards of the statute

and of the Treasury regulations under Section 482 raises broad issues of appropriate limits on the use of governmental taxing authority. These include issues about what activities are appropriate for various agencies of government under U.S. concepts for a system of checks and balances associated with separation of powers among the legislative, executive, and judicial branches.

Was it appropriate for the Treasury and the Service to suggest, for the Congress to enact, or for the administration to approve its enactment? In the White Paper the Treasury and the Service pointed out the lack of substantive rules of law needed to determine the correct amount of tax due in major categories of international transactions. Congressional and administration officials who agreed to enactment were aware of this and knew that the administration was at work developing new substantive guidelines for regulations and international agreements. Some of these officials also knew that an ultimate issue in this area for both taxpayers and taxing authorities concerns the portion of a taxpayer's total taxable income from international transactions that is to be subject to the tax of each country claiming jurisdiction, and that there were not in force in internal U.S. law or in treaty tax law all the rules needed for attributing items of income, expense, profit, or loss to each country of geographic source.

Now that the penalty has been enacted, was it appropriate for Treasury and IRS officials to publicly announce their intention to start enforcing it without waiting for development of regulations? General rules of interpretation are needed by IRS field agents to assure uniform and nondiscriminatory application of the penalty to various taxpayers, some of whom are direct business competitors. Is it appropriate for Treasury officials to be publicly speculating about the benefits of an *in terrorem* approach which would withhold publication of rules providing needed guidance to field agents and taxpayers about the standard of taxpayer compliance expected to avoid the penalty? Taxpayers are not the only persons to whom the reasonable cause/good faith standard applies; the Service is not supposed to impose a penalty where a taxpayer's standard for compliance with the tax law measures up to its requirements. Is it appropriate for Treasury and Service officials to be advising international business taxpayers that they can free themselves from the financial threat of imposition of the new penalty if they accept invitations by Service tax enforcement officials to enter into private negotiations for advance pricing agreements about the basis to be followed for taxing future international transactions under conditions where (1) substantive rules of generally applicable law needed for determination of acceptable transfer prices are still not in force, and (2) the terms of any agreements reached by direct business competitors with the Service or other countries'

taxing authorities are not known to the taxpayer and are required to be kept secret by the Service?[114]

In each of these situations it would seem more appropriate for government officials, especially Service enforcement personnel, to resolve these issues without overzealously using their power. Tax revenues and penalties must be collected with respect for rules of law and principles of fair play.

In tax legislative policy making and drafting sessions many years ago, the author discovered that it was commonplace for proposals to be made, generally by Service representatives, for provisions of tax law operating *"in terrorem,"* or through terror. Sections 482 and 269 were often cited as prime examples of such provisions. The idea, it was explained, was to adopt provisions that would have only vague standards but that would delegate to tax enforcement personnel very broad powers intended to accomplish two objectives. First, they would frighten taxpayers from entering into transactions within the scope of those broad powers. Second, where taxpayers nevertheless ventured or happened into such grey areas, the powers delegated would enable the Service to resolve disputes on a case-by-case basis "in the light of all the relevant facts and circumstances." It was said that the standard for deciding permissible conduct could be decided later when the Service had before it an actual case. This approach contrasts with spelling out "mechanical" or "bright-line" rules defining permissible and impermissible taxpayer conduct. The latter would "only" serve as a road map for taxpayers and their sophisticated advisers to use to devise courses of conduct that would "really" only be legislatively sanctioned schemes of tax avoidance. The broad, *in terrorem* approach, would entail less work for the legislative draftsmen and Members of Congress, thus saving time for them to address other matters, while responsibility for the difficult, technical, and time-consuming task of developing regulations and rules for disposition of actual cases would be left to the Treasury and the Service.

Sharp controversies often arose between advocates of the competing approaches. A particularly sharp controversy arose when a provision that would have amended Section 482 to add a subsection dealing with sales of tangible property between U.S. corporations and their foreign affiliates was considered in 1962. Unless the taxpayer could demonstrate its use of an arm's-length price under the comparable uncontrolled price method, taxable income would be apportioned between related parties under a formula based on the relative economic activities of the affiliated companies. This provision was included in the House version of the legislation,[115] but was not enacted. The conferees agreed to the omission by explaining that Section 482 as it stood was already broad enough to permit such an approach. They recommended that the Treasury explore the possibility of promulgating regulations "to provide additional guidelines and formulas for the alloca-

tion of income and deductions in cases involving foreign income."[116] The Treasury, however, in the revised regulation promulgated in 1968, declined to follow the conferees' recommendation to adopt formulary apportionment based on relative economic activities of affiliated parties.

That particular contest in 1962 was "won" by proponents of the *in terrorem* approach. However, experience under Section 482 in the intervening 30 years suggests that the "victory" may well have been Pyrrhic.[117] That the dollar amount in controversy in Section 482 disputes before the U.S. Tax Court alone stood at over $25 billion as of the end of 1990, and was rising, may be taken as one measure of the cost of the *in terrorem* approach. Another such measure may be the energies and monies of governmental and private sector personnel consumed by the deluge of policy-level actions taken over the last decade by the Congress, the Treasury Department, and the Service to shore up and buttress enforcement of the existing regime.[118] Similarly, the potentially huge revenue stakes discussed at the July 1990 public hearings before the House Ways and Means Subcommittee on Oversight may be taken as a further measure of the costs of that regime. When policy makers give tax enforcement personnel the responsibility for making needed law on an *in terrorem*, case-by-case, "facts-and-circumstances" basis, they are not likely to get a structure of generally applicable, realistically grounded rules of law that provide international tax collectors and business taxpayers with the clear-cut, flexible advance guidance they need.

The high costs of using the *in terrorem* approach over the last 30 years argue strongly for shifting away from it. The Service should not be given the power to make law in the area on such a basis. The Service should also recognize that compliance difficulties in the area are often caused by the nature of the present regulatory regime rather than by taxpayer "abuse" or "cheating."[119] All concerned might be better served by an approach founded on the working hypothesis that taxpayers carrying on international business within the United States and within the other free and democratic nations among our major trading partners would respond better to a rule of law than a reign of terror. The new approach ought to accord primary importance to the task of developing a system founded firmly on generalized, workable, and realistic principles of law; a system that provides international business taxpayers and taxing authorities alike with the clear-cut guidance they need. To achieve that result probably requires even more active leadership by senior policy level officials in the U.S. Treasury Department.

One provocative note about the appropriate roles for different branches of government in handling issues under Section 482 in keeping with U.S. traditions for separation of powers and checks and balances was sounded

recently by Arthur L. Nims, III, Chief Judge of the U.S. Tax Court. In a speech before the International Fiscal Association he stated:

> Before I close, I would like to make one further comment on a matter which I find rather troubling. In the 1989 Committee Report which accompanies HR 3299, and specifically regarding new section 6038A(e), there is a statement that the conferees are informed that the Tax Court is interpreting the standard of review in section 482 cases so as to permit the Court to effectively substitute its own judgment for that of the Commissioner. In 482 cases, the standard of review is whether the Commissioner's determination is arbitrary, capricious or unreasonable. I wish to assure Congress and all others that the Tax Court has no intention of routinely substituting its judgment for that of the tax administrator. Nevertheless, many of the cases we've been talking about involve hundreds of millions of dollars, sometimes determined by the Commissioner in the most generalized way, and in a free society such as ours, it is essential that review by an independent tribunal like the Tax Court be available. And nothing must be done to undermine that independence.[120]

Conclusion and Recommendations

The new penalty does not address the central problem that is at the root of the growing maze of unresolved disputes and problems in the area of multinational taxation of income from international business transactions. That problem is a lack of rules of law for determining how to allocate to various countries and to various entities within a controlled group the worldwide revenues and expenses and other items that enter into calculation of the tax profit or loss from international business transactions. The lack of law is a failure not of taxpayers but of government—at many levels. In the United States, Congress has failed to make rules of statutory law that resolve these questions in specific cases, having chosen instead to delegate that rulemaking power to the Treasury and the Service. The Treasury and the Service have failed to make principled rules of regulatory law to resolve in specific cases the host of hypothetical questions of theoretical economics generated by the regulatory regime they created or are defending. That is followed by a failure of the Service, in litigation and in administrative proceedings asserting tax deficiencies under Section 482, to state what rule or principle of law it is that leads it to assert that a business underpaid its tax.[121] In the case of foreign governments, there generally is a comparable failure to prescribe rules of law that resolve these questions in specific cases. On the part of both the United States and foreign governments, there is a failure to arrive at principled agreements regarding the rules of law that are to be used, whether in competent authority or arbitration proceedings or elsewhere, for resolving conflicts among countries' differing laws as applied in specific cases.

Much of the institutional failure of the U.S. government to make rules of law is not accidental; rather, it is the result of conscious and deliberate decision making. Congress made a series of deliberate decisions to delegate responsibility for developing rules of law to the Treasury and the Service, and to leave the responsibility there, despite strong evidence that their regulations were not working.[122] The Treasury and the Service have deliberately rejected "bright-line" rules or "safe harbors" in favor of disposition on a case-by-case basis with reference to "all the facts and circumstances" of each case.[123]

Such Treasury and Service decisions are being made in the context of a set of procedural rules in U.S. tax law that go well beyond attaching the usual presumption of correctness to any tax adjustment proposed by the tax collector: they require the taxpayer to bear the extraordinarily heavy burden of proving such an adjustment to be "arbitrary, capricious or unreasonable,"[124] without the taxpayer being given the benefit of a statement in advance of what is reasonable. The scales of tax justice are thus weighted heavily in favor of the U.S. tax collector's exercise of the enormous power associated with the vagueness of the standards prescribed in the statute and in the existing Treasury regulations under Section 482. That may help explain a long-standing reluctance on the part of many IRS tax enforcement officials, and even some Treasury Department tax officials, to abandon the present regulatory regime: doing so would entail relinquishing the enormous and loosely constrained power they now have to dispose of Section 482 issues on a case-by-case basis. Yet there is nothing in their record of enforcement over the last 30 years to suggest that enforcement personnel "know best" the "right answer" to each of the multitudinous issues presented. If they do or think they do, let their view of the "right answer" be reduced to writing in a set of proposed rules that are open, through the usual processes provided under our form of government, for review, acceptance, revision—or even rejection—by those subject to the rule and by other duly constituted organs of government.

The law imposing the new penalty naturally does not purport to provide any new substantive rules for answering hypothetical questions in the international, intercompany transfer pricing area. The new penalty is certainly not a solution to the puzzle; it is only a symptom of views that have been a major cause of the puzzle. Those views include a mistaken belief that "out there somewhere" is a hypothetical arm's-length transfer price for nonarm's-length intercompany transactions that is "right" for each case even though it is not stated in the law; a mistaken belief that taxpayer "abuse" or "manipulation" avoids using the "right" hypothetical price; and a mistaken belief that the "right" price is ascertainable if only multinational business taxpayers, especially large ones, are punished suffi-

ciently. Those views also include a mistaken belief that every organization carrying on international business is operating at a taxable profit and that its failure to report a taxable profit to the United States is evidence of taxpayer "abuse."

The authors of the new penalty are right in sensing that the fiscal stakes in the international transfer pricing area may be enormous, for both the United States and its trading partners. Transactions across national boundaries by some (but not all) business organizations—U.S. and foreign—are generating net profits of magnitudes that offer the United States and its trading partners important sources of income tax revenue. They are right in believing that it is not possible, given the present state of law, or more accurately absence of law, to ascertain whether the United States or any other country for that matter, is collecting its "fair share" of income tax revenue from international business transactions. There simply are not in force the rules of internal U.S. tax law, let alone internationally accepted rules of tax law, that permit the Congress, the Treasury, the Service, and taxpayers to know in advance and with reasonable certainty how much income tax the U.S. government is entitled to collect from a series of international business transactions.

Members of Congress also are understandably frustrated and concerned about their inability to find out whether the United States is getting its "fair share." The Congress, international businesses, and the U.S. public at large, have important stakes in knowing with reasonable certainty what the tax rules of the international game are—before it is played.

Members of Congress, the Treasury Department, and other Administration officials have the power to make the changes in U.S. substantive law needed to solve the problem, as well as to seek multilateral international agreements for reducing and resolving international conflicts of law on the subject. Hopefully, recognition of this will spur pursuit of a more constructive form of remedial governmental action than that reflected in the new U.S. tax penalty regarding transfer pricing. The recommendations set forth below are offered for dealing with the new transfer pricing penalty and some of the problems to which it was addressed.

1. The Treasury Department, in the study and report to Congress on Section 482 mandated by the Omnibus Reconciliation Act of 1990, should recommend repeal of the new transfer pricing penalty retroactively to the date of its enactment.

2. The Treasury Department, in the same report, should recommend against imposing any new penalties for transfer pricing dispute differences until after there are new substantive rules of law in force in the United States that will permit principled and reasonably accurate advance determi-

nations of acceptable transfer prices and profit or loss allocations for international intercompany transactions.

3. The Treasury Department and the Service should consider announcing a moratorium on enforcement of the new penalty during the period before promulgation of final regulations prescribing new substantive rules to make it possible to uniformly interpret and apply both Section 482 and the new penalty, (including the "reasonable cause/good faith" exception).

4. Pending legislative repeal or administrative suspension of enforcement of the new transfer pricing penalty, the Treasury Department and the Service should, by regulations and by rulings, interpret the requirements of the "reasonable cause/good faith" exception as being satisfied in any case where the regulations do not provide clear substantive rules permitting a reasonably accurate determination in advance of transfer prices and allocations of profit or loss (including all revenue and expense items involved) that will be acceptable under Section 482 for the particular transaction in question.

5. The Treasury Department should assign top priority to vigorous pursuit of its efforts to develop and to promulgate specific new substantive rules that will permit principled and reasonably accurate geographical and intercompany allocations of profit-related items arising from international transactions on terms that are acceptable to the United States and have the potential for gaining acceptance by other countries. The Congress should support and encourage such efforts by the Treasury Department; it also should insist that the new rules not be intentionally vague or designed to operate *in terrorem* but that they be specific, understandable, and informative about what is expected.

6. Representatives of international businesses should work cooperatively in support of the above objectives. They should unify and intensify their activities in support of efforts by the government of the United States and other countries to develop substantive rules for international allocation of profit-related items. They should share their expertise and compliance experience to produce rules that are specific, understandable, and workable.

The author gratefully acknowledges the many valuable comments, questions, and suggestions regarding this article that were furnished by Professor Herbert I. Lazerow, Editor of *The International Tax Journal*, by the author's partner, Paul T. Metzger, Esq. of Chicago, Ill., by his colleagues at the bar, Francis A Lavelle, Esq. of Washington, D.C., Charles J. Kerester, Esq. of Cleveland, Ohio, and Edward O. Craft, Esq., of Bloomington, Ind., and by Emil Sunley Ph.D., an economic consultant of Washington, D.C.

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1. Omnibus Budget Reconciliation Act of 1990, Pub L No 101-508, § 11312, 104 Stat 1388, 1388-454 (1990) (amending IRC § 6662(c)).

2. Other such measures include: (1) A provision (§ 11316) requiring the Treasury Department to conduct a study of "the application and administration of Section 482", including the effectiveness of this new penalty in increasing compliance with Section 482, and to report to the Congressional tax-writing Committees by March 1, 1992 the results of that study, together with such recommendations as it may deem advisable; (2) A provision (§ 11314) that retroactively applies to 25 percent-or-more-foreign-owned corporations for prior open taxable years beginning before July 11, 1989 the information reporting, record-keeping, and U.S. corporate agent designation requirements enacted in 1989 as IRC § 6038A; (3) A provision (§ 11315) that extends to any foreign corporation doing business in the U.S., whether or not 25 percent-foreign owned, information reporting and record keeping requirements like those applicable to 25 percent-foreign owned corporations but that apply whether or not the information or records are about a "related party transaction"; (4) A provision (§ 11317) that extends from 6 to 10 years the period of limitations for instituting proceedings for collection of taxes after their assessment; (5) A provision (§ 11311) that, in the case only of a corporation, suspends the running of the statute of limitations against assessment of any tax for any period (whether before or after enactment of the Budget Reconciliation Act of 1990) during which the corporation and the Service are involved in judicial proceedings for the enforcement of an IRS "designated summons"; and (6) A provision (§ 11313) that permits the Service to disclose confidential tax returns and tax information to persons who provide certain services, such as economists or other consultants engaged by the Service in IRC § 482 cases.

3. U.S. legislative and administrative actions over the last decade relevant to international transfer pricing include the following: (1) Enactment in 1982 of the sanction barring a taxpayer from introducing into evidence in a U.S. court proceeding any "foreign-based documentation" covered by a "formal document request" by the Service with which the taxpayer substantially fails to comply. IRC § 982. (2) The legislation enacted in 1986 to prevent the tax cost of dutiable inventory imports from exceeding U.S. Customs value. IRC § 1059A. (3) The 1986 "super royalty" legislation amending IRC § 482 to require income from the transfer or license of intangible property to be "commensurate with the income attributable to the intangible." Pub L No 99-514, 100 Stat 2085 (amending IRC § 482 to add second sentence(1986)). (4) The 1986 directive of the conferees on the Tax Reform Act of 1986 (Pub L No 99-514) that "a

comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and careful consideration should be given to whether the existing regulations could be modified in any respect." HR Conf Rep No 841, 99th Cong, 2d Sess II-638(1986). (5) The 1986 legislation imposing the "branch tax" on certain dividend or interest remittances abroad from U.S. operations of foreign corporations. IRC § 884. (6) The 1988 "White Paper" on rules for international intercompany pricing prepared by Treasury Department and IRS National Office personnel in response to the 1986 Congressional directive. *A Study of Intercompany Pricing, prepared by Treasury Department's Office of International Tax Counsel and Office of Tax Analysis, and Internal Revenue Service's Office of Assistant Commissioner (International) and Office of Associate Chief Counsel (International), Discussion Draft Released Oct. 19, 1988,* [hereinafter *White Paper*] reprinted by Bureau of National Affairs as Special Supplement to Daily Executive Report No 203 (Oct 20, 1988). (7) The 1989 legislation imposing, on corporations owned 25 percent or more by foreign persons, far reaching information reporting, record keeping, and U.S. corporate tax agent designation requirements in respect of transactions by the reporting corporation with "related parties". IRC § 6038A. (8) The 1989 legislation designed to inhibit, by denial of a U.S. income tax deduction for "excessive interest", the "stripping of earnings" from a U.S. corporation controlled by a U.S.-income-tax-exempt foreign person. IRC § 163(j). (9) The introduction on March 20, 1990 by U.S. House Committee on Ways and Means Chairman Rostenkowski and other Members of Congress of a bill which proposed to: (a) retroactively apply the 1989-imposed-information and record-keeping requirements to prior open taxable years of reporting foreign corporations; (b) empower the Service unilaterally to extend by as much as three years the usual three-year period against assessment of tax deficiencies in cases where the deficiency is "foreign-related" and the Service determines it cannot assess a deficiency within the usual period "by reason of delay or other actions of the taxpayer;" (c) impose U.S. income and withholding tax on gains of 10 percent foreign shareholders from sales of equity securities in U.S. corporations. HR 4308, 101st Cong, 2d Sess, "The Foreign Tax Equity Act of 1990." The bill was accompanied by a suggestion by Chairman Rostenkowski that consideration be given to instituting a new rebuttable presumption for determining taxable income of a U.S. corporation from the sale of property acquired from a foreign person under which a transfer price would be used that results in the U.S. corporation having taxable income from the sale of not less than 50 percent of the combined taxable income of the U.S. corporation and any related person from such property, unless the taxpayer could prove otherwise to the satisfaction of the Service 136 Cong Rec H 928-29 (daily ed, Mar 20, 1990) (statement of Mr. Rostenkowski). (10) The initiation by the Treasury and the Service of a project looking to the promulgation, at promised dates which have repeatedly been extended, of revised substantive U.S. tax regulatory rules for pricing transfers covered by IRC § 482. (11) The Treasury/IRS announcement of an intention to institute a new administrative procedure under which the Service, upon a request from a taxpayer, would rule in advance (in a so-called "Advance Determination Ruling" ("ADR") or "advance price agreement"), on a Section 482 transfer pricing methodology—but not price—it would accept, and join with the taxpayer in advocating for acceptance by foreign tax authorities as well under advance "competent authority proceedings" contemplated by bilateral

income tax treaties. "Full Text of Draft Revenue Procedure on Advanced Transfer Pricing Rulings," 2 *Tax Notes Int'l* 565 (June 1990). Since that announcement of intention, the Service instituted advance pricing agreement procedures by publishing Revenue Procedures 91-22, 91-23 & 91-24, 1991-1 IRB 11 (Mar 18, 1991). (12) The Treasury's announcement in 1990 of initiatives with foreign tax authorities to arrive at procedures for compromising international transfer pricing disputes. See, e.g., Treasury Accepts U.K., West German Offers of Cooperation on Transfer Pricing," *Daily Tax Rep* No 174, at G-8 (Sept 7, 1990).

4. *Hearings on Tax Underpayments by U.S. Subsidiaries of Foreign Companies Before the Subcommittee on Oversight of the House Committee on Ways and Means, 101st Cong. 2d Sess.* (hereinafter *Hearings*) held July 10 and 12, 1990, *Serial* 101-123.

5. Turro, "Ways and Means Panel Blasts Foreign Firms for Tax Dodging," 48 *Tax Notes* 247 (July 16, 1990).

6. Statement of Commissioner of Internal Revenue Fred T. Goldberg, Jr., presented July 10, 1990 at *Hearings*, supra note 4, at 61, 63; see also 62 & 186-87.

7. See particularly the excellent written statement of Professor Stanley I. Langbein, submitted August 1, 1990 for the record of the *Hearings*, supra note 4 at 393.

8. Statement of Assistant Treasury Secretary Kenneth W. Gideon, presented July 12, 1990 at the *Hearings*, supra note 4, 235 at 237-39 and at 249-50. Secretary Gideon also stated, when asked by Congressman Flippo whether foreign controlled U.S. subsidiaries are paying their fair share of taxes, "That is a question I cannot answer." Id. at 260.

9. The assertion here is not the broader one made by some to the effect that "the arms-length approach" is not working; that may or may not be so, depending on the particular meaning that is given to that phrase. The more limited statement here is that the approach under the current U.S. Treasury regulations under IRC § 482 is not working.

10. On January 23, 1991, U.S. Tax Court Judge Edna Parker, in remarks before a group of members of the District of Columbia Bar Association, indicated that about $35 billion of tax is in issue in cases pending before that court on the large-case docket, and estimated that 80 percent to 85 percent, or $28 to $29.75 billion, involved transfer pricing disputes under IRC § 482. Judge Parker noted that the volume of IRC § 482 cases before the court, which is controlled not by the court but by the Service and taxpayers, is likely to increase as a result of increased IRS enforcement activities in the area.

On March 1, 1991, U.S. Tax Court Chief Judge Arthur L. Nims, III, in remarks in Chicago before members of the U.S.A. Branch of the International Fiscal Association, reported that the amount in controversy in cases on the Tax Court's docket for large cases involving potential deficiencies of more than $10 million rose dramatically from about $19 billion at the end of 1989 to over $32 billion at the end of 1990 as a consequence of the IRS large-case audit program.

11. At the Congressional subcommittee hearings in July, the Commissioner of Internal Revenue stated that the number of international examiners had increased from 150 in 1977 to 499 in 1990, and that the Service was currently auditing approximately 520 foreign-controlled corporations. He indicated the Sevice plans to audit about 600 foreign-controlled corporations to cover those

reporting more than 50 percent of total assets and receipts. *Hearings*, supra note 4, 61 at 79 & 80, under V.1. The Service Assistant Commissioner (International), in remarks on August 9, 1990 noted that the 1987 tax returns of those 600 foreign-controlled corporations represented total assets of $530 billion and gross receipts of $355 billion.

12. The study of IRC § 482 required by section 11316 of the 1990 Budget Act (supra note 2 (para (1)) is to include an examination of (1) the effectiveness of the amendments made by all the compliance provisions of the Budget Act "in increasing levels of compliance" with IRC § 482, (2) the use of advanced determination agreements, (3) "possible legislative or administrative changes to assist" the Service in increasing compliance with IRC § 482, and (4) coordination of the administration of IRC § 482 "with similar provisions of foreign tax laws and with domestic nontax laws."

13. IRC § 6662.

14. Notwithstanding that an "underpayment" to which the new penalty applies is defined broadly to include "any tax imposed by this title" (IRC § 6664(a)), application of the new penalty is restricted by the statute (IRC § 6662(e)(1)) to a "valuation misstatement under chapter 1." The new penalty therefore is to apply only to transfer price misstatements made on returns of those income taxes which are imposed under those IRC §§, namely, IRC §§ 1–1399, which comprise chapter 1. This excludes transfer price misstatements made on returns of taxes imposed by chapters 2–6 of the income tax subtitle A (e.g., the excise tax imposed by IRC § 1491 on the transfer of property by a U.S. person to a foreign corporation or other entity), or taxes imposed by later subtitles, such as the estate and gift taxes, employment taxes, miscellaneous excise taxes, etc.

If the regular tax is computed by reference to some amount other than taxable income, as where the alternative minimum tax applies, such other amount is treated as the taxable income base for the new penalty. IRC § 6662(e)(3)(C).

15. IRC § 6662(a).

16. IRC § 6662(h).

17. IRC § 6662(e)(1)(B).

18. IRC § 6662(e)(1)(B)(i).

19. IRC §§ 6662(e)(1)(B)(ii) and 6662(e)(3). In computing this $10 million threshold (and the $20 million threshold for a "gross" valuation misstatement), there is excluded any part of the net increase in taxable income attributable to any redetermination of a price if it is shown that there was "reasonable cause" for the taxpayer's price determination and that the taxpayer "acted in good faith" in respect of the price. IRC § 6662(e)(3)(B)(i). The report of the conferees states that "the conferees intend that the same standard of reasonable cause and good faith apply for purposes of this modification as would otherwise apply to the valuation misstatement penalty under section 6664(c)." HR Conf Rep No 964, 101st Cong, 2d Sess 1076(1990).

Also excluded in computing those thresholds is any portion of the net increase in taxable income which is attributable to any transaction solely between foreign corporations, unless the treatment of the transaction affects determination of any such foreign corporation's U.S. source income or taxable income effectively connected with conduct of a U.S. trade or business. IRC § 6662(e)(3)(B)(ii). Thus, the report of the conferees indicates that there will be

no penalty under Section 482 on this second, "net annual effect" basis as the result of IRS adjustment under IRC § 482 of the price of a transaction solely between two foreign corporations not doing business in the U.S., where one of the corporations has a U.S. shareholder whose net IRC § 482 transfer price adjustment, computed without regard to any subpart F inclusion resulting from the foreign-to-foreign adjustment, does not exceed the $10 or $20 million threshold. HR Conf Rep No 964, 101st Cong, 2d Sess 1076 (1990).

The increase for the year is determined without regard to amounts carried to that year from earlier or later years. IRC § 6662(e)(3)(A).

20. IRC § 6662(h)(2)(A).

21. The statute by its literal terms does not provide that liability for the penalty on this basis may be eliminated or offset by equivalent but contrary-direction price deviations for other transfers which favor the taxpayer. Moreover, there is a provision in the Treasury regulation stating that "[s]ection 482 grants no right to a controlled taxpayer to apply its provision at will, nor does it grant any right to compel the district director to apply such provisions." Treas Reg § 1.482-1(b)(3). However, Treas Reg § 1.482-1(d)(3) offers a basis for precluding such a harsh result in cases to which it applies. Such cases are illustrated by three examples in the regulation. These may be generally described as (1) those where the Service is required to set off, against an IRC § 482 adjustment that otherwise would be made, the effect of other nonarm's-length transactions in the same taxable year between related members of a controlled group, and (2) those in which the Service is required to consider the effect of an arrangement between members of such group for reimbursement within a reasonable period before or after the taxable year.

Notwithstanding that, rules that might not have permitted the aggregation suggested in the preceding paragraph were included in a preliminary draft of a notice of proposed Treasury regulations regarding accuracy-related penalties that was made available to the public by a private publisher in February 1991. "Preliminary Draft of 11-30-90 of Department of the Treasury-Internal Revenue Service Notice of Proposed Rulemaking (IA-015-90) on Accuracy-Related Penalty", published in *Daily Tax Rep* (BNA) No 34, at L-12-28 (Feb 20, 1991) [hereinafter Draft]. Shortly after release of the Draft, however, the Service published in the *Federal Register* a notice of proposed rulemaking on certain aspects of the accuracy-related penalty. This declared that the earlier Draft was made available to the public without Service approval, that the notice contains substantial revisions from the earlier draft, and that taxpayers and tax practitioners should not in any way rely on the earlier Draft or draw any inferences from the changes. Treasury/IRS Notice of Proposed Rulemaking [IA-015-90] RIN 1545-A058, 56 Fed Reg 8943, 8944 (proposed Mar 4, 1991) [hereinafter, Notice]. The Service also stated in that Notice that the regulations proposed there do not address how the valuation misstatement penalty "applies in the context of transaction between persons described in Section 482 or of net Section 482 transfer price adjustments". The Service further stated that it will at a later date issue one or more notices to address such issues, but that it "will not wait until issuance of such notices. . .to begin asserting [the negligence and valuation misstatement penalties]. . .in those other contexts." Id. at 8944. The Notice further states that rules provided in the proposed regulations for the "reasonable cause/good faith" exception "do not consider how the reasonable cause exception should be applied in the context of transactions between per-

sons described in Section 482 or of net Section 482 transfer price adjustments." Id. at 8947.

Despite these assertions by the Service, certain rules in the earlier Draft should be noted because of their importance should they be applied by the Service, either on audit or in later regulations, to Section 482 pricing adjustments. First, the Draft proposed regulation had rules for determining when multiple assets may and may not be aggregated and treated as a single "property." The Draft stated the general rule that such aggregation determinations shall be made "in the manner that most clearly reflects the actual nature of the transaction involved" (emphasis supplied), and then illustrated the rule with examples. Draft Prop Treas Reg §§ 1.6662-5(c)(3)(ii), 1.6662-5(c)(3)(iii).

Second, the Draft proposed regulation had rules regarding the circumstances under which tax return valuations for different "properties" may and may not be aggregated for purposes of determining the amount of percentage deviation from the "correct" value and for purposes of applying the $5,000 and $10,000 de minimis limitations. Draft Prop Reg § 1.6662-5(d). The general rule stated was that neither the values as claimed on the return nor those as corrected may be aggregated in determining whether there is a penalizable deviation of 200 percent, or 400 percent, or more. The rule further stated that the portion of any tax underpayment attributable to valuation misstatement of one property will be combined with that attributable to another for purposes of determining whether the de minimis limitation is met.

22. IRC §§ 6662(e)(1)(B)(i), 6662(e)(3)(A).

23. IRC § 482.

24. Treas Reg § 1.482-(1)(a)(3).

25. IRC §§ 6662(e)(1)(B)(i), 6662(e)(3)(A).

26. HR Conf Rep No 964, 101st Cong, 2d Sess 1075 (1990).

27. Id. See also *Description of Chairman's Mark for Proposed Democratic Alternative to Budget Revenue Reconciliation Proposals Reported by the Committee on Ways and Means on October 10, 1990*, at 32-3, prepared by the Staff of the Joint Committee on Taxation (Oct 11, 1990).

28. Assume, for example, there is a dispute whether fee income received by a subsidiary rendering desalinization engineering services in and to foreign country S was or was not generated by or "attributable" in whole or in part to the subsidiary's use of intangible property, such as a copyrighted or patented design or process or trade name or any other form of intangible or tangible property held by its parent in country P. Assume also that there was an adjustment to either company's U.S. tax liability resulting from a determination that all, or none, of the fee income was attributable to the subsidiary's use of the parent's property. Would that be a penalizable adjustment "attributable to" a valuation misstatement and to the "price" for use of the parent's property or for the "price" of the engineering services rendered in and to country S? It would seem that it should not be. Such an adjustment grows out of a dispute that really is not about "price" or value of consideration. It is about what is or is not consideration "for" something else and will be settled only by resolution of complex and nebulous factual and allocation issues.

Nevertheless, the preliminary draft of the proposed Treasury regulation under the accuracy-related penalties (supra note 21) contained a provision which would treat an underpayment as "attributable to" a valuation misstatement if

it is "capable of being attributed to" a valuation misstatement, "notwithstanding that the underpayment also may have been caused by other conduct." Draft Prop Treas Reg § 1.6662-2(b). This is an extreme position that is questionable both as a matter of statutory interpretation and as a matter of policy. To treat "attributable to" as meaning "capable of being attributed to" is to accord validity to a interpretation that is questionable. It seems clear that an underpayment should not be subjected to the penalty merely because a tax deficiency is "capable" of being connected with valuation disputes, especially where, in fact it is not.

Also worth noting is another questionable provision in the draft of the proposed regulation which would invariably treat a valuation misstatement as being "gross" and subject to the maximum 40 percent penalty in any case where the correct value of a property is zero. Draft Prop Treas Reg § 1.6662-5(e). See also the cases and materials discussed in HB McCawley, "Civil Tax Penalties," *Tax Mgmt Portfolio* 441-2nd (1990), II.C.6.d. at A-20.

29. IRC § 6662(b)(3). The penalty for valuation overstatements as first enacted in 1981 applied only to individuals and closely held and personal service corporations. It did not apply to other corporations until it was integrated into the accuracy-related penalty in the 1989 reform.

30. IRC § 6662(b)(1).

31. IRC § 6662(b)(2).

32. IRC § 6663.

33. IRC § 6662(e)(2).

34. IRC §§ 6662(e)(3)(B)(i), 6664(c). Another commentator initially concluded, without citation of authority, that "[t]his good-faith exception does not apply to taxpayers that have committed a 'substantial valuation misstatement' under the first part of the definition of that term [relating to substantial deviations from the price ultimately found to be correct]." M McIntyre, "The New U.S. Penalty for Transgressions Involving Improper Transfer Prices," 2 *Tax Notes Int'l* 393, at 394-95 (Apr 1991). That conclusion, however, is contrary to the statutory language of IRC § 6664(c) and to the conferees' understanding of the operation of the new penalty as stated in HR Conf Rep No 964, 101st Cong, 2d Sess 1074 and 1075 (parenthetical clause in third sentence under "Conference Agreement")(1990). The commentator later corrected his initial conclusion to take account of IRC § 6664(c). M McIntyre, "Good Faith, Reasonable Cause, and the U.S. Penalty for Transfer Pricing Abuses," 2 *Tax Notes Int'l* 493, 497 (May 1991).

35. IRC § 6665(a).

36. IRC §§ 6601(e)(2), 6665(a)(2).

37. IRC §162(f); Treas Reg § 1.162-21(b)(1)(ii).

38. IRC § 6662(d)(2)(B).

39. IRC § 6662(d)(2)(C).

40. Prop Treas Reg § 1.6664-4(b) (emphasis supplied).

41. *Treasury/IRS Notice of Proposed Rulemaking*, supra note 21, 56 Fed Reg 8943 at 8947 & 8944.

42. See also infra note 119 for remarks to that effect on May 18, 1991 by the Treasury Department tax official.

43. HR Conf Rep No 101-247, 101st Cong, 2d Sess 1392-93 (1989).

44. For a discussion of the case law under the reasonable cause/good faith exception and the negligence penalty, see McCawley, "Civil Tax Penalties," supra note 28 at A-10-12. For further comparison and discussion of the possible merger of the standards for application of the negligence penalty and other accuracy-related penalties, see text infra under "Summary" in second paragraph after notecall 113 and under "The other penalties available" after notecall 68; and see ABA *Penalty Studies Report*, infra note 95 at 31-39, 41-42, 43-48 & 51-56.

45. Pub L No 101-508, supra note 1, § 11312(c).

46. Some might argue that the correct time for measuring the retroactivity of the new transfer pricing penalty is the date for filing the tax return rather than the earlier date of the actual occurrence of the transfer to be priced. Such a contention does not appear to be tenable in the context of a transaction-specific penalty such as this which is designed to reinforce normative standards to govern taxpayer conduct in shaping the contractual terms of the business arrangements under which a transfer is to be consummated.

47. Office of Management and Budget, *Budget Summit Agreement*, Table IIC, Revenue Raising item C7, "Foreign Compliance Provisions, under "additional provisions not from the Foreign Tax Equity Act of 1990", reprinted in *Daily Tax Rep*, No 191, at L-1, 7-8 (Oct 2, 1990).

48. *Hearings*, supra note 4 at 251-52.

49. *Hearings*, supra note 4 at 169, 173. After responding that the question of whether to add sanctions was worth looking at, Commissioner Goldberg advised the subcommittee that "all the penalties today require that we prove the guy is a bad guy." Id. at 169. That, of course, ignores the no-fault nature of the accuracy-related penalties for substantial understatement of income tax and for valuation overstatement.

50. See remarks of IRS Associate Chief Counsel(International) Steven R. Lainoff, reported in *Daily Tax Rep* No 205, at G-6, (Oct 23, 1990), in *49 Tax Notes* at 947, 948 (Nov 26, 1990), and in *Highlights & Documents* at 1615, 1616 (Nov 21, 1990); remarks of Treasury Department Attorney-Advisor Rom Watson reported in *Daily Tax Rep* No 208, at G-2 (Oct 26, 1990) and No 236, at G-1 (Dec 7, 1990); and remarks of Chief of Staff of Joint Committee on Taxation Ronald Pearlman reported in *Daily Tax Rep* No 221, at G-3-4 (Nov 15, 1990).

51. *White Paper*, supra note 3 (para (6)); ch 3A, last two paragraphs at S-5 and 6. (Page numbers in citations to the White Paper are to the version as reprinted in the supplement to BNA's *Daily Executive Rep*, No 203 (Oct 20, 1988).

52. Id. at S-5-6.

53. Id. at S-7

54. Id. at S-12.

55. Id. at S-8.

56. This reflects the kind of "strict liability" approach to tax penalties which was rejected by the Commissioner's Task Force on Civil Tax Penalties on grounds of being unfair and likely to undermine the standard of behavior

desired for taxpayer compliance. *See Comm'r's Report*, infra note 94 at VIII-35 (under "Types of Penalties," and "1. Strict Liability").

57. This is not meant to suggest any lack of need for accurate reporting by a taxpayer of information in his or her possession that is needed for application of the tax laws or any lack of need for enforcement efforts and some supporting penalties. Indeed, having that is vital to any self-assessment tax system which, like that of the U.S., relies on voluntary taxpayer compliance.

58. This important fact is frequently neglected in commentaries which mistakenly speak of the arms-length standard as a requirement of the statute. That it is not, means that the Treasury and the Service are free at least from such a statutory constraint in selecting which of the many approaches available shall be administratively prescribed.

59. Treas Reg § 1.482-1(b) provides in part as follows:

> (b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Treas Reg § 1.482-1(b)(1).

For this purpose the regulations define the term "true taxable income" to mean

> . . [I]n the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. . . . Treas Reg § 1.482-1(a)(6).

60. *White Paper*, supra note 3 (para (6)) at S-4.

61. Id at S-8.

62. Id. at S-4.

63. Id at S-12. Regarding intangible property, the *White Paper* also states:

> . . the difficulty in applying section 482 to high profit potential intangibles is that unrelated party licenses of comparable intangibles almost never exist. Id at S-13. The intangible property portion of the regulations contemplate a failure to find appropriate comparables. Where they are unavailable, the regulations list 12 factors to be taken into account including. . . The regulation offers little or no guidance, however, in determining how much relative importance particular factors are to be given. Id at S-4.

64. Id at S-18. Further comments regarding the absence of rules for transfer pricing appear elsewhere in the *White Paper* at pages S-2 (4th para of sec A and 3rd para of sec B), & S-4 (last sentence of sec D.1).

65. *For example*, Treas Reg § 1.482-1(d)(4) states:

> If the members of a group of controlled taxpayers engage in transactions with one another, *the district director may distribute, apportion, or allocate* income, deductions, credits, or allowances *to reflect the true taxable income* of the individual members under the standards set forth in this section and in §1.482-2 *notwithstanding the fact that the ultimate income* anticipated from a series of transactions *may not be realized* or *is realized during a later period*. For example, ...*The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members*. (Emphasis supplied.)

It will be noted that the regulation reaches this result of creating and taxing income never in fact realized by defining "true taxable income" for this purpose (in the subjunctive) to mean the hypothetical or constructive "taxable income . . . which *would have* resulted to the controlled taxpayer *had it* dealt with the other member[s]. . . of the group at arm's length." (Emphasis supplied.) Treas Reg § 1.482-1(a)(6).

The reader thus is instructed by the Treasury regulation that reality is to be discovered only by treating "true" taxable income to mean income as hypothesized on terms to be prescribed by the Treasury. This brings to mind passages from *Alice in Wonderland*, and particularly the following dialogue between Humpty Dumpty and Alice:

> "When I use a word", Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean—neither more nor less."
>
> "The question is," said Alice, "whether you can make words mean so many different things."
>
> "The question is," said Humpty Dumpty, "which is to be the master—that's all."
>
> *Alice in Wonderland*, Lewis Carroll (Gray edition 1971), as quoted in F. Reed Dickerson, *Fundamentals of Legal Drafting* (Little, Brown & Co., 2d ed., 1986) 141 at note 5.

66. See, e.g., Langbein, "The Unitary Method and the Myth of Arm's Length," 30 *Tax Notes* 625 (Feb 17, 1986).

67. Among these are possible new directions on which the author has been working in collaboration with Charles I. Kerester, Esq. which are planned for presentation during proceedings of the National Tax Association to be held in Williamsburg, Va. in Nov., 1991.

68. *Description of Chairman's Mark*, supra note 27 at 32.

69. One commentator has asserted, without citation of authority, that "[t]he Congress, the Treasury Department, and the IRS have all concluded that the fraud penalties and other general Code penalties that might be applied to police transfer-pricing abuses have not been working." M McIntyre, "The New U.S. Penalty for Transgressions Involving Improper Transfer Prices," supra note 34 at 395. Neither the record of the July 1990 hearings of the House Subcommittee on Oversight nor the Treasury/IRS White Paper support that conclusion.

70. IRC §§ 6662(b)(1), 6662(c); Prop Treas Reg §§ 1.6662, 1.6664.

71. IRC § 6662(b)(2); Prop Treas Reg §§ 1.6662, 1.6664.

72. IRC § 6662(b)(3); Prop Treas Reg §§ 1.6662, 1.6664.

73. IRC § 6663.
74. IRC § 6038A.
75. IRC § 6038C.
76. IRC § 6723.
77. IRC § 6701.
78. IRC § 6694.
79. IRC § 7201.
80. IRC § 7203.
81. IRC § 7206.
82. IRC § 7212.
83. *Hearings*, supra note 4 at 251.
84. Id. at 252.
85. Id. at 169 (Mr. Flippo) and 175-76 (Mr. Milano).
86. Id. at 177 (Mr. McGrath, Mr. Goldberg & Ms. Lewin).
87. Id. at 175-76 (Mr. Shaw), 230 (Mr. Shaw), 297 (Mr. Duncan) and 298-99 (Mr. Dorgan).
88. Id. at 165 (Mr. Flippo), 193 (question 7.) and 199 (answer to question 7.).
89. See testimony of Commissioner Goldberg and Mr. Romoff, infra at notecall and note 90; Assistant Secretary Gideon, supra at notecall 83; Dr. Granfield, *Hearings* at 352-53; and Ms. Lewin, *Hearings* at 177-78.
90. Id. at 169. When questioned further by Congressman Shaw, Commissioner Goldberg testified: "We have been notably less than successful in our efforts to assert civil fraud penalties, much less criminal penalties, against large corporate taxpayers." Id. at 176.

When questioned again by Congressman McGrath about possible use of disciplinary action against tax return preparers, Commissioner Goldberg testified: "I think that, again, I hate to be a broken record here, but I think if you listen to the reality of how difficult these cases are to make, how—." Id. at 177.

In a similar vein, Mr. Edward Romoff, an experienced IRS international group manager in Los Angeles, testified as follows:

> I have to say that you are talking about penalties. From my experience, I feel very fortunate if we can get a 482 issue sustained notwithstanding the penalty. . . .
>
> Again, we have a torturous road with regard to setting up and maintaining a 482 case. It is not an easy thing to do. Some fraud cases that have nothing to do with 482 are easier to make than a 482 case, in my opinion. That is part of the problem. It is a torturous road that we have to take.

Id. at 178.

91. In the *Hearings*, supra note 4, *see* the oral statement of Treasury Assistant Secretary Gideon at 253-54 (1st and 4th colloquies with Mr. McGrath), 255-56 (4th and 5th colloquies with Mr. Anthony), 260, 261, and 262, and his written statement at 239-43; the oral statements of IRS Commissioner Goldberg at 62, 63, and 67-71, and his written statement at 73 and 79-82.
92. In the *Hearings*, supra note 4, see the oral and written statements of: Ms. Frances Zuniga at 139-146; Dr. Michael E. Granfield at 351-59; Mr. Roscoe Egger at 347-51; Prof. James E. Wheeler at 360-375; Prof. Stanley I. Langbein at 393-402; Multistate Tax Commission at 442-445.

93. Id at 140, 143 & 144.

94. IRS Commissioner's Executive Task Force, *Report on Civil Penalties* (1989) [hereinafter *Comm'r's Report*] *reprinted* as special supplement to BNA's *Daily Tax Rep* No 35 (Feb 23, 1989).

95. ABA, Section of Taxation, *Penalty Studies Report* (July 28, 1988) (hereinafter *ABA Penalty Studies Report*).

96. *Comm'r's Report*, supra note 94 at VIII-29; see also material on retroactivity at V-31 (2d full para, including text of note 52); *ABA Penalty Studies Report*, supra note 95 at 2 (para 5: "Since it is not fair to punish acts done prior to the adoption of the punishment, nor acts deterred by penalties not even in existence when the acts are done, penalties should not be adopted retroactively").

97. *Comm'r's Report*, supra note 94 at 1 (1st para under pt I) & II-2 ("revenue raising is not rationally related to compliance objectives"); and *ABA Penalty Studies Report*, supra note 95 at 2 (para 4).

98. *Budget Summit Agreement*, supra note 47.

99. See, e g., HR Conf Rep No 964, 101st Cong 2d Sess (1990) at 1076.

100. *Comm'r's Report*, supra note 94 at 1 (4th para & subpara 3), I-4 (3d para) II-1, 2 & 3, & VIII-30. It is stated, e.g., that ". . . penalties are more effective if, in addition to imposing a financial sanction, they clearly support a normative obligation. A penalty will not achieve this normative dimension if the underlying obligation (i.e., standard of behavior) is not understood or does not exist." Id at VIII-30. See also *ABA Penalty Studies Report*, *supra* note 95 at 1 (principle 2), 2 (principles 3 & 4) & 12-15.

101. *White Paper*, supra note 3 (para (6)) at S-18.

102. *Comm'r's Report*, supra note 94 at I-4.

103. Id. at III-3-5 (under B.) and VIII-28-30 (under B.).

104. Id. at III-4 (under "1. Adequate Severity").

105. *Hearings*, supra note 4 at 103 & 95.

106. *Comm'r's Report*, supra note 94 at 1 (under Part I, 4th para, "principle 1"); at III-2 (under III-A); at VIII-23-25 (under "Fairness").

107. See also discussion supra note 46.

108. *Comm'r's Report*, supra note 94 at 1 (under Part I, 4th para, "Principle 1"); at II-2 (4th para); III-3 (under "2. Proportionality": ". . .a penalty should be proportionate to the culpability of the noncompliant taxpayer and to the harm caused by the instance of noncompliance."); VIII-25-28 (under "2. Proportionality"); at VIII-43 (recommendation 6.a regarding "Proportionality"); *also*, *ABA Penalty Studies Report*, supra note 95 at 11 (para 3, "Appropriateness").

109. Id at II-2 (3rd and 4th paras).

110. IRC § 6662(c); Prop Treas Reg § 1.6662-3.

111. *Comm'r's Report*, supra note 94 at II-2 (3d and 4th full paras); at III-6-9 (under "D. Administrability"); at VIII-26 (under "C. Similar Penalties for Similar Acts"); at VIII-31-35 (under "D. Administrability").

112. Prop Treas Reg § 1.6664-4(a).

113. *Comm'r's Report*, supra note 94 at III-9.

114. See Rev Procs 91-22, 91-23, and 91-24, 1991-1 IRB 11 (Mar 18, 1991).

115. HR 10650, 82nd Cong 2d Sess § 6 (1962); HR Rep No 1447, 87th Cong 2d Sess 537-38 (1962).

116. See, e.g., *Hearings on HR 10650 Before the Senate Committee on Finance*, 87th Cong, 2d Sess pt 7, at 2913, 3011-3012 (1963) (statements by P Seghers and DN Adams); and HR Rep No 2508, 87th Cong, 2d Sess 18-19 (1962).

117. A "Pyrrhic victory" is "too costly," "referring to the victory of Pyrrhus, King of Epirus, over the Romans at Asculum in 279 B.C., in which the losses were extremely heavy." *Webster's New Universal Unabridged Dictionary* 1470 (2d ed., New York, Simon & Schuster, 1979).

118. For a description of 19 such actions taken since 1982, seven of which occurred just last year, see supra notes 1, 2 and 3 and related text.

119. For a representative sampling of such views, see the *Hearings*, supra note 4, passim, and the recent article by M McIntyre, supra note 33 at 395. An indication that the *in terrorem* approach to transfer pricing issues is still very much alive appeared in recent remarks to the effect that leaving it to the courts to develop the meaning of the reasonable cause/good faith exception as applied to the new transfer pricing penalty might have a useful, *in terrorem* effect. Remarks of U.S. Treasury Department Associate Tax Legislative Counsel Rom Watson before a meeting on May 18, 1991 of the Committee on Affiliated and Related Corporations of the Section of Taxation of the American Bar Association, as reported by Lee A. Sheppard in 91 *Tax Notes Today* 111-5 (May 21, 1991).

120. Judge Arthur L. Nims, III, Remarks, supra note 10.

121. Relevant to this point, the Chief Judge of the U.S. Tax Court, in an address concerning large transfer pricing and foreign source income cases before that court, made the following statement in connection with the first pre-trial memorandum required of the parties by the judge assigned to the trial of a large IRC § 482 case:

> . . .In this connection, *it has been my experience as a trial judge that getting an agreed statement of the issues is the single most difficult, and most significant, part of the job.* It seems that notwithstanding how much audit time has preceded the formulation of the deficiency notice, *the Commissioner's view of the case may well continue to be an evolving process requiring in his mind quite a bit of additional discovery before he willingly agrees to be pinned down to a theory.* The taxpayer by the same token often professes to remain mystified by any IRS theory that falls much short of a full capitulation. For example, if the case involves a government challenge to transfer pricing of tangible property under section 1.482-2(e) of the Regulations, without an agreement on the precise question presented the taxpayer will simply introduce a mass of evidence to challenge the application of all four of the methods prescribed by the regulations for determining an arm's length price. The government will do the same. This, as you can see, results in a sprawling and lengthy trial, involving the introduction of a great deal of evidence, much of which ends up on the cutting room floor. The opposite side of the coin can be a taxpayer's efforts to circumscribe the government's attempt to get at the true facts of the case so that the government will be forced to present an incomplete and badly prepared defense. *Ideally, the government's theory should have been formulated by the time the deficiency notice is mailed.* If this is the case, and the judge succeeds in getting the issue agreed upon, the

taxpayer can simply prepare his case for trial confident that he knows the position he is required to rebut. The government, at the same time, can comfortably limit any formal discovery to putting flesh on the bones of a theory already well-articulated. . . . (Emphasis supplied).

Chief Judge Arthur L. Nims, III, U.S. Tax Court, Remarks made in Chicago at the Annual Meeting of the U.S.A. Branch of the International Fiscal Association (Mar 1, 1991).

122. An outline of the history of Congressional decisions in this regard prior to 1989 is in the Treasury/IRS White Paper, supra note 3 (para (6)), ch 1, pt A at S-2, ch 2 at S-3-4, and ch 6 at S-4-14.

123. A prominent example of this is in the Treasury/IRS White Paper. After review of a number of proposals for "safe harbors, or simple, mechanical, bright-line tests that may be used in lieu of the fact-specific arm's length inquiry under Section 482," it was concluded: "While the possibility that useful safe harbors could be developed is not categorically rejected, additional Section 482 safe harbors are not recommended at the present time." Id. note 4 at S-18-19. It was also concluded there that:

> No amount of general discussion of these standards [for exact comparables] is likely to turn them into objective tests. As in all matters concerning transfer pricing, facts and circumstances must determine the outcome of specific cases. . . . Id. at S-21.

124. Credit for emphasis of this important point of procedural law belongs to the author's colleague at the bar, Charles J. Kerester, Esq. of Cleveland, Ohio.

TESTIMONY OF

KEVIN L. KEARNS

PRESIDENT

U.S. BUSINESS AND INDUSTRIAL COUNCIL

TAX AVOIDANCE BY FOREIGN CORPORATIONS

I. Introduction

In July 1990, an investigation by the House Ways and Means Oversight Subcommittee into alleged tax underpayment by foreign-owned U.S. subsidiaries revealed the following facts:

- At least half of the companies surveyed had substantially lowered or eliminated their U.S. tax liability[1].
- Examination of income tax returns of 18 U.S. subsidiaries of foreign automobile and motorcycle manufacturers revealed that in tax year 1987, 10 of these companies reported gross receipts of $38 billion. Less than 1% of this figure ($366 million) was paid in income taxes to the federal government[2].
- In 1987, foreign firms paid income taxes of only $1.9 billion on total assets of $959 billion. Their true tax liability, based upon a more realistic before tax rate of return of 15%, has been estimated to be approximately $48 billion[3].

These facts lend credence to the argument that foreign manufacturers have gained unfair advantage over their U.S. counterparts by under-reporting the pre-tax income of their U.S. subsidiaries, thus significantly reducing their U.S. federal income tax liability.

In response, the firms defend low reported rates of return by stressing their traditional emphasis on market share over short term profit. However, this argument fails to account for the fact that while reported profits are either relatively static or down, investment, income and market share are up. These are clear signs of significant distributions to parent corporations.

Foreign cartels, especially Japanese cartels (known as keiretsu) use tax evasion and money laundering on a massive scale to gain access to the American market and to export profits out of the United States tax-free. Transfer pricing abuses have victimized American businesses which have had to compete with Japanese subsidiaries in the United States paying little or no income taxes here. The cost to American taxpayers amounts to billions of dollars in lost revenues.

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[1]Patrick Heck, Statement to House Ways and Means Oversight Committee hearings on tax underpayment by foreign-owned U.S. subsidiaries, July 10, 1990.

[2] Heck, p.5.

[3]The Detroit News, August 24, 1990, p.1E.

II. How Tax-Avoidance Works

The methods are straightforward. Huge quantities of products are shipped to the United States. Keiretsu-controlled subsidiaries located in the United States buy these goods, as well as financial products and services connected with the goods, from their Japanese parents at fraudulently inflated prices called transfer prices. The prices are set so that the sale of the product in the American market results in little or no profit for the subsidiary. This mechanism creates a profit outflow from subsidiary to parent consisting of income which escapes taxation in the United States.

Ultimately, targeted American producers and industries, unable to respond effectively since they bear the burden of genuine taxation, are driven out of business, with a few stragglers resorting to off-shore production. The targeted American market then accepts the low-value added role of a warehouser, or at best, an assembler. Higher paying, more skilled jobs remain in Japan and other foreign countries. Once this occurs, the second phase begins. Distribution channels then can be intimidated and dominated. And more significantly, transfer prices to the warehouser and assembler can be raised to almost any level.

Let's be clear about one thing: Tax evasion is an element of gaining and holding market share. Political resistance can be overcome, or at least contained, by nationally coordinated lobbying, public relations and promotional efforts. We have seen just such a well-coordinated campaign against correcting transfer price abuses in recent weeks.

President Clinton made the correction of transfer price abuses a main element of his campaign. He repeated his promise to stop this practice and get foreign corporations to pay their fair share of taxes. Immediately after his election, the foreign lobbying campaign started. News stories and op-ed pieces began to appear with the specific intent of preventing the new president from fulfilling his campaign pledge.

These stories alleged that the money was not there; or that asking foreign corporations to pay their fair share of taxes would force them to relocate elsewhere; or foreign direct investment in this, the world's largest and most lucrative market, would dry up overnight; or that the increase in taxes would be passed on to the American consumer, with the result of higher prices and inflation; or finally that foreign nations would reciprocate against American corporations doing business in their countries.

Although none of these arguments holds any credence upon examination, the vehemence with which they are advanced leads one to conclude that there is more at issue than just a few tax payments. Transfer pricing is not some esoteric, theological

debate. It is a huge, high stakes game being played for the future of the American economy.

We have already seen the devastating effects of such strategies in the steel, autos, consumer electronics industries. We are experiencing them now in flat panel displays, advanced materials, and other high-tech businesses. The problem is worse than ever today as Japan's export-driven economy seeks to recover from its own recession through increased exports to this country.

The U.S. government has not adequately attacked the problem. In the few cases that the IRS has brought against companies engaging in fraudulent transfer pricing schemes, it has settled for pennies on the dollar. Abandoned by the government, American businesses have not yet found a way to counter tax evasion schemes aimed at them as part of a business strategy.

Examples of specific techniques employed by foreign manufacturers in order to reduce tax liability are set out in the cases I now present.

i. Transfer Pricing

In March 1989, Sony's U.S. subsidiary reported profits of only $11 million on gross sales of $4.4 billion. Such statistics are indicative of the fact that Japanese and other foreign corporations have been overaggressive in using transfer prices as a way of reducing U.S. income tax liability. Parent companies are charging their U.S. subsidiaries artificially inflated prices for sub-assemblies and finished products in order to reduce the reported income and tax liability of these subsidiaries.

Federal law stipulates that transactions between the parent and subsidiary should take place at "arms-length" prices, i.e the price that the parent would charge an independent seller in the open market. Examples of the breach of this regulation abound. For example, one foreign automobile manufacturer sold cars to its U.S. distributor at prices averaging $800 more than identical cars shipped to its Canadian distributor[4]. Prosecution for breach of federal regulation proves difficult, however. The charges brought against Honda Motor for padding transfer prices were dropped in 1984, due to the absence of a rigid formula for calculating arm's length prices[5]. Until the concept of an "arms-length" transaction is more clearly defined, the practice is sure to continue.

ii. Miscellaneous Deductions

[4]Heck, p.6.

[5]The Japan Economic Journal, August 11, 1990.

Aggressive transfer pricing is but one strategy employed to reduce subsidiary income. Parent companies charge their subsidiaries excessive amounts for insurance, advertising and transportation.

With regard to insurance, in one case cited, a U.S. subsidiary's inventory was insured under a separate policy, but the Japanese parent company billed the subsidiary for insurance twice.

Excessive advertising expenses charged to subsidiaries also reduces taxable income. In one instance, a subsidiary's advertising expense exceeded 50% of its gross profit. Advertising expenses for other firms in the same industry averaged 3 to 5% of gross profit.

There is evidence that Japanese automobile manufacturers charge their subsidiaries more for ocean freight than they charge to unrelated companies for identical products carried aboard the same vessel on the same day, arriving at the same port[6].

iii. Financial Accounting Practices

Japanese accounting regulations serve to increase the incentive of Japanese corporations to employ transfer prices to suppress U.S. subsidiary profits. Companies without U.S. stock exchange listings present only consolidated financial statements to stockholders. Income from subsidiaries is accounted for in the form of dividend income only[7]. This provides an incentive to transfer profits from the subsidiaries to the parent in the interests of increasing the stock price.

Furthermore, Japanese tax law offers deductions not provided under U.S. law. For example, when a Japanese corporation acquires the assets of another company, the amount of goodwill recorded on the balance sheet is tax deductible, a practice prohibited in the U.S.[8]

iv. Uncooperativeness

There is evidence of efforts by Japanese corporations to obstruct IRS investigations of alleged income under-reporting. Some

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[6]Heck, p.7.

[7]This accounting practice, referred to as the "cost method" is prohibited in the U.S. by the Financial Accounting Standards Board.

[8]James E. Wheeler, Statement to House Ways and Means Oversight Committee hearings on tax underpayment by foreign-owned U.S. subsidiaries, July 12, 1990.

companies have gone so far as to decentralize their U.S. operations in an effort to reduce the possibility of detection by the IRS. Others use complicated transactions to establish elaborate paper trails in an attempt to avoid detection.

Other obstruction techniques are less subtle. One case describes how IRS officials conducting an examination of subsidiary offices of a Japanese multinational were assigned desk space in a 6' X 6' guard hut. In another instance, IRS officials who requested specific documents were presented with 40 boxes of documents without an index. The relevant documents were found to be missing[9].

The IRS readily admits that its auditors and attorneys are presently "outgunned" by the legal and financial expertise foreign corporations employ to evade full tax liability under the U.S. federal tax code. The successful development and resolution and tax underpayment cases requires a complex economic analysis of corporate transactions. The IRS is currently understaffed in the economist function, and officials must wait approximately eight months for one of its 40 economists to be assigned to tax underpayment cases. The IRS is unable to assign 12 large transfer pricing cases in the Western region because the region's eight economists are overworked[10].

Thus, a combination of taxpayer uncooperativeness and insufficient resources has degraded the investigative effectiveness of the IRS. Given these circumstances, it is hardly surprising that investigations of alleged tax underpayment by subsidiaries of Japanese automobile manufacturers take approximately 10 years to complete.

The above facts indicate conclusively that at a time when the Government grapples with the problem of a budget deficit and the controversial issue of tax increases, aggressive tax filing by the U.S. subsidiaries of foreign companies has resulted in billions of dollars in tax revenue being denied to the U.S. Treasury. As of February 1990, cases in appeals and litigation involved tax underpayment of approximately $13 billion, this amount being considered by many to be just the tip of the iceberg[11].

Furthermore, the de facto tax advantage enjoyed by foreign companies puts U.S. companies, such as auto manufacturers, into a position in which they are unable to turn a profit, and are unable

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[9]Heck, p.11.

[10]Heck, pp. 8-11.

[11]Heck, p.7.

to contribute to the U.S. Treasury.

III. Recommendations

What specific steps can be taken to ensure that, in the realm of taxation policy at least, U.S. and foreign manufacturers will compete on a level playing field? Here I offer some of the specific recommendations which have been made to date.

- **More public information**: The biggest difficulty in combatting the under-reporting of taxable income is the lack of publicly available information on the financial status of the U.S. subsidiaries of foreign companies, including information on their tax payments.

  Currently, when stock-exchange listed U.S. companies file their forms 10-k, they are required to disclose detailed information including sales by region and by product. But when foreign corporations file their 10-k equivalent, form 20-f, this requirement is waived. The public therefore loses a valuable source of information on the financial performance of foreign-owned U.S. subsidiaries. This deficiency should be corrected.[12].

- **A uniform international accounting system**: Introduction of such a system may be necessary to ensure equal treatment for U.S. and foreign manufacturers. As illustrated earlier, the accounting standards set by the Japanese Ministry of Finance do nothing to discourage transfer pricing practices[13].

- **Reform of the U.S. federal tax code**: The introduction of an "Alternative Minimum Tax" has been suggested. The proposed tax would adjust reported taxable income by removing many of the deductions now allowed to arrive at a new taxable income to which the alternative tax rate can be applied. A shortcoming of this proposal is that it does not directly attack inflated transfer prices.

- **More attention to transfer pricing**: One useful analytical tool might be the application of an assumed rate of return on the assets of subsidiaries of foreign corporations to generate more realistic profit figures from which tax liability can be more clearly established[14].

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[12] Wheeler, p. 5.

[13] Wheeler, p.6.

[14] Wheeler, p.10.

A more rigid definition of "arms length" pricing would also be helpful in addressing the problem of artificially high transfer prices. (This issue must be resolved at the Government level, as under current arrangements, the Japanese Ministry of Finance reimburses Japanese corporations required to pay additional taxes to the IRS to avoid double taxation.)

- Additional resources for the IRS: The IRS admits that its auditors and attorneys are presently outmatched by the legal and financial experts foreign corporations currently employ to evade their full tax liability in the United States. Increased resources are necessary to increase investigative effectiveness.

- Self-help for American Business: Given government intransigence and incompetence, American business must fend for itself in this area. The solution is both controversial and novel. American business should respond to this problem with techniques used successfully against organized crime. The Racketeer Influenced Corrupt Organizations Act, known as "RICO," used in combination with federal anti-money laundering laws, can combat anti-competitive market effects of keiretsu tax evasion.

  RICO provides a domestic legal solution to what has been treated as a matter of international diplomacy. Curbing predatory foreign trade practices through RICO would neutralize foreign nations' powerful political resources and provide a private remedy for harmful trade practices which the government has been unwilling to acknowledge and unable to control.

  Through the legal principle of extraterritorial jurisdiction, the offshore parent could be within the reach of American courts, both as party and for evidence-gathering purposes if illegal activity either took place in the United States or had an effect here. Those with first-hand knowledge of wrongdoing have an incentive to come forward and tell what they know. Federal reward laws can entitle whistleblowers to significant percentages of any monies recovered by the IRS.

TESTIMONY OF

KEVIN L. KEARNS

PRESIDENT

U.S. BUSINESS AND INDUSTRIAL COUNCIL

TAX AVOIDANCE BY FOREIGN COMPANIES ACCELERATES DECLINE IN U.S. COMPETITIVENESS

Tax cheating, as Americans as diverse as Al Capone and Leona Helmsley have learned, is an incendiary topic. There exists little sympathy for tax dodgers. No one argues that rich people or big businesses, because they face more complicated provisions of the tax law, should be accorded leniency if they came up short on the amount of money they owe to the government

Yet the recent Helmsley affair pales in comparison to the tax cheating being undertaken today by foreign corporations. The I.R.S. is investigating the possibility that foreign companies operating in the United States are engaged in widespread and systematic tax fraud. According to I.R.S. data, of the 36,800 foreign-owned companies filing tax returns in 1986, more than half reported that none of their income was taxable. And on an aggregate figure of $543 billion in total receipts, foreign businesses operating in the United States took $544 billion in tax deductions. In other words, they reported a taxable income of minus $1 billion.

Foreign firms pull off these tax avoidance schemes by overcharging their subsidiaries here for the goods, technology or services, such as consulting, they provide to them. One common overcharge mechanism is called "transfer pricing". The foreign-owned subsidiaries here import into the U.S. materials, parts or sub-assemblies from their overseas parents, which they then sell after incorporating them into a finished product. The tricky part is this: the foreign parent companies charge their U.S. subsidiaries substantially more than the import product is actually worth. On the subsidiary's books, part--or perhaps all, depending on the transfer price--of the revenues earned from U.S. sales are offset by the inflated charges from the parent company. And instead of showing true profits earned on its sales here, the tax return of the subsidiary declares reduced, or no, taxable income.

Why transfer profits earned in the U.S. back to the parent company if they are just as liable to be taxed there (and often at higher nominal rates)? While many believe international businesses do not view themselves as citizens of any particular country, in fact, many companies do consider themselves citizens of their home countries. For them, if they are going to pay taxes, they prefer to do so where their money can improve both the physical and human infrastructure of the country they are tied to over the long run. The parent company has a vested interest in seeing that roads, ports, schools, laboratories, and health and standard of living of its valued home country workers improve and provide it with a growing competitive edge.

Of course, the assumption that a foreign firm which engages in fraudulent transfer pricing will actually pay all the taxes due at home is probably faulty. A company that cheats on its taxes in one country is not going to pay them in full in another country. It is

likely that some or all of the transferred profits will be "lost" in the trans-oceanic shuffle through accounting tricks.

In addition, this mechanism may be winked at by the parent company's government. After all, most governments are interested in giving their companies an extra edge in international competition; they may not look too closely for these transferred profits. Strictly speaking, the parent company is cheating the U.S. government, not the host government. And if the American government is not clever or conscientious enough to collect the taxes due, why should the parent company's government do the American government's work?

The fundamental purpose of all this double dealing by foreign firms is distortion of the market mechanism in their own favor. If their U.S. competitors are paying taxes, and they are not, the foreign firms gain a tremendous competitive advantage through the additional capital they then have on hand. With these extra funds, they can outspend their competitors on R&D to capture or create markets with pioneering new products, invest more in new capital equipment to improve manufacturing efficiency and lower costs, or expand and refine the sales and service infrastructure of their firms. By converting tax liabilities into profits, foreign corporate tax cheaters can really put the squeeze on their American competitors.

Additional market distorting effects of tax cheating compound the problem of American companies trying to compete. The more money foreign firms have available through tax schemes, the less they have to borrow and their costs of doing business are lower. One of the primary problems facing American companies trying to compete is the high cost of borrowing money in the United States. Because American companies have to pay more of the money they make back to their lenders, it is tougher for them to be profitable.

Tax avoidance distorts the credit markets in several additional ways. Since American companies show lower earnings in comparison to their non-taxpaying competitors, their stock prices are in effect discounted accordingly and it costs them more to raise money in the stock market. In addition, to the extent that profits are lower through tax payments, U.S. companies' credit ratings are lower than their competitors who do not pay taxes. Again it costs them more to borrow to do business. And as weakened U.S. companies lose the competitive battle to their foreign adversaries and their revenues drop, they pay fewer taxes thus adding to the federal budget deficit.

The federal government and the American consumer are also victims of tax fraud through the credit markets. It is self-evident that to the extent that tax revenues are lower, the U.S. government is hurt directly: but to make up the difference, it also has to borrow more. This borrowing pushes up the cost of

capital for everyone and affects the entire economy. Jobs are lost not only in U.S. companies trying to compete with foreign businesses but throughout the economy as interest rate sensitive industries like housing, construction and autos decline in the face of higher rates. With tax avoidance occurring in the billions of dollars, the multiplier effect further increases the cost of capital and negatively impacts the rate of U.S. economic growth.

Probably the most galling aspect of the issue is the fact that such a large proportion of U.S. tax revenues are needed to fund our $300 billion defense budget. While the foreign parent companies are transferring profits home to create new infrastructure there, our companies are saddled with the cost of defending the rest of the free world, including these foreign tax cheaters with whom they are locked in life or death economic struggles.

To cope with a situation of this magnitude, the federal government needs extraordinary means. The President should establish an independent task force immediately to get a grasp on the full extent of the problem and to go after the cheaters. There can be no coddling of allies here. If American companies were engaged in collusive activity to cheat on their taxes, the IRS would pursue them with a fervor. A key benefit granted to foreign companies setting up here is that they receive "national treatment", i.e. U.S. investment policies do not distinguish between foreign companies and U.S. companies. When it comes to enforcing our tax laws, the same equal treatment principle should apply.

The federal government should be using the tax cheating issue not only to get the guilty companies to pay what they owe, but also as leverage in other important economic negotiations. However, the temptation in the executive branch will be to manage this crisis so that diplomatic and security relationships are not harmed by a blow-up over tax cheating. That means that the tax cases may not be pursued vigorously. Rather than risk offending allies with a request that their companies pay their fair share, the federal government, after years of court battles with the cheaters, as it has in the past, will likely settle for a fraction of the amount that is owed. Once again the American people will be forced to subsidize the unfair practices of our trading partners. Hence the need for an independent task force and for the Congress to be involved.

The Congress should participate in two ways. First, through the House Ways and Means Committee and the Senate Finance Committee, Congress must watch to make sure that the executive branch acts decisively in catching tax-evading foreign companies. Congressional hearings to explore the problem are mandatory. Second, Congress must generate legislation which eliminates tax evasion through transfer pricing.

One possibility is to establish a port-of-entry transfer tax for all materials, parts, goods, services and technology imported into the United States. Such a tax would create an incentive not to inflate transfer prices. The transfer price and the tax paid at port of entry would establish a baseline for the IRS when the subsidiary later files its income tax return. Credit for tax already paid would be granted. Another possibility is to switch to a value added tax rather than an income tax for business. While these and other methods of rectifying the situation need further exploration, Congress should take up the challenge immediately. Because it is easier to correct tax cheating than it is to implement the structural and cultural changes necessary to reduce the cost of capital, Congressional action on this issue can directly improve American competitiveness.

Of course, there is also an important fiscal dimension to this story. A political stalemate is currently holding up meaningful progress on reducing the federal budget deficit, while increased U.S. competitiveness waits on the sidelines. In an election year, little movement is likely. That means that deficit reduction will take place, if at all, through one-time savings and minor "revenue enhancements".

The Administration budget submission calls for more money for I.R.S. enforcement, which it estimates will bring in an additional one billion dollars. However, foreign firms' tax cheating is estimated to be in the $12 billion range. Imagine what a grand compromise on the budget--featuring $12 billion in new tax receipts from tax cheaters plus an equal amount in authentic spending cuts--would do toward achieving genuine deficit reduction and enhancing overall U.S. competitiveness.

A final note: Tax cheating by foreign companies operating in the U.S. underscores an important point about ownership often dismissed by laissez-faire free market theoreticians. It does make a difference if America's factories and businesses are not owned by Americans. Rapacious behavior on the part of foreign-owned corporations retards U.S. economic growth and contributes to a decline in our standard of living. Tax cheating by foreign companies is thus not only illegal and unfair, it is ultimately a breach of faith with the American people.

BIO: Kevin L. Kearns, a former State Department official, is the President of the U.S. Business and Industrial Council, an advocacy group representing the interests of small and medium-sized American-owned businesses.

Financial Times, March 5, 1993, Page 5

Foreign companies warned over higher US taxes

By David Dodwell, World Trade Editor

EUROPEAN companies would be rash to think the US Congress has relented in its demands for higher taxes on international businesses, Washington tax lawyers told a meeting of the American Chamber of Commerce in London yesterday.

The EC will need to lobby in unison if President Bill Clinton's ambitious deficit reduction package, intended to raise a net $245bn over the next five years, is not to include swingeing new transfer pricing rules, the meeting was told.

Multinational companies operating in the US – the largest group of which are headquartered in Britain – breathed a deep sigh of relief two weeks ago when Mr Clinton said in his State of the Union address that new transfer pricing rules would raise just $3.6bn over five years. His campaign speeches last year had hinted that foreign concerns would have to pay an extra $40bn in taxes.

However, Mr Greg Jenner, partner in the US law firm McDermott, Will & Emery, warned that higher taxes could yet be levied. President Clinton might be forced to find a further $20bn in revenue to fund programmes demanded by Congress as a price for approving the administration's deficit reduction package. "It is important to keep in mind that the president's proposals were the first shot," he said. "Foreign companies are perceived as easy targets in the US, and should not think they are out of the woods."

Demands that foreign companies pay more taxes are based on popular views that, in order to minimise taxes, many manipulate prices charged on components passing from parent companies to their US subsidiaries.

Foreign companies complain that these charges are unfounded, and say the new rules proposed by President Clinton – which call for transfer price analyses to be carried out at the same time as tax returns are filed – will show this. In the US, economists worry that higher taxes, and the uncertainty created by the transfer pricing debate, will discourage new foreign investment.

Mr Michael Burrell, managing director of the lobbying group Westminster Strategy, said Mr Clinton's populist appeal meant that lobbying by European companies "will have to be framed in terms of the interest of the American people, and what foreign investment means in terms of US jobs".

Given the strength of domestic lobbying pressure for foreign companies to pay higher taxes, he insisted that French, German or British companies would need to make their case as European companies. "Europeans have to be seen as saying the same thing, in the same voice, with co-ordinated action formulated in coalition."

Companies needed to target four bodies: the European Commission, EC national governments, members of the Group of Seven industrial countries, and US state governments – particularly the home bases of such key US legislators as Congressman Dan Rostenkowski of Illinois, chairman of the House ways and means committee, and Senator Daniel Moynihan of New York, chairman of the Senate finance committee.

Time, December 30, 1992, Page 39

BUDGET

The Foreigner-Tax Folly

Clinton's plan to raise $45 billion from non-U.S. companies is a pipe dream, economists say, and reflects a shortsighted view of outside investment

By S.C. GWYNNE WASHINGTON

MAYBE BILL CLINTON REALLY BElieved that the numbers in his economic plan would add up. Or maybe he was exercising the political campaigner's God-given right to fudge and exaggerate. Either way, those days are gone. Now that he's President-elect, his relatively pain-free prescriptions face a stark reality as they make the transition from promise to practice.

Probably Clinton's most dubious budget idea is his proposal to squeeze foreign companies doing business in the U.S. for $45 billion in taxes over four years. He would rely on that measure to provide nearly one-third of all the new taxes he will need to finance his program to reduce the deficit and increase public investment. The stratagem is characteristically Clintonian: an apparently painless (for Americans) way of generating revenue without raising unpopular levies like the gasoline tax or touching popular spending programs like Medicare.

Clinton's intention is to clamp down on non-U.S. companies that have been illegally shifting their profits abroad. Some companies do this by inflating their transfer prices, which are the amounts they charge their American subsidiaries for goods and services. This scheme boosts the profits of the parent companies back home and reduces the taxable earnings of the domestic affiliates. Clinton's advisers, who extrapolated their numbers from a study by a House Ways and Means subcommittee, are confident that they can generate enormous new revenues by stopping or penalizing those practices.

The problem with this plan, many economists say, is that it vastly overestimates the extent to which non-U.S. companies have been evading taxes. "The $45 billion number is out of sight," observes Gary Hufbauer, an economist at the Institute for International Economics in Washington. "He might get $6 billion in additional revenues." Says economist Rudolph Penner, the former director of the Congressional Budget Office: "The numbers are so far off what is reasonable that it's difficult to know where to begin—$1 billion seems more likely than $45 billion." Aside from Clinton's proposal, the highest estimate of the revenue to be gained by closing loopholes on foreign companies comes from the Internal Revenue Service: at most, $13 billion over four years.

The main reason that Clinton's idea will not work is that foreign companies like Honda, which invested in auto and motorcycle plants in Ohio in the 1980s and helped create thousands of new U.S. jobs, have little motivation to move their profits elsewhere. Germany's corporate tax rate is 51% and Japan's is 46%, while the rate in the U.S. is only 34%. "There's just not much incentive for these companies to move their profits to higher-tax countries," says Hufbauer.

LOUIE PSIHOYOS—MATRIX

A squeeze on foreign companies could discourage outside investment like this Honda factory in Marysville, Ohio

Although some non-U.S. companies surely do evade American taxes, the IRS's previous efforts to crack down on violators have borne relatively little fruit. Earlier this month the Japanese electronics giant Matsushita, which sells products in the U.S. under the Panasonic and Quasar brand names, reached an agreement with the IRS to pay a settlement in that kind of dispute. The amount was a mere $4.8 million. At least 47 Japanese companies in the U.S. have been involved in similar cases within the past five years. Many such companies are now taking Matsushita's accommodating approach, which will produce as much as $6 billion in new U.S. revenue over the next four years, far short of what Clinton's camp has hoped for.

Clinton's miscalculation of the gains to be had from taxing foreign firms masks a larger problem: a shortsighted view of outside investment in the U.S. "We're in a real struggle for foreign capital, and we're going to need huge amounts of it," says Jeffrey Garten, a professor at Columbia University's business school. "If the U.S. tries the gunboat approach, we're going to put the country at a huge disadvantage."

Given the poor return he is likely to get from trying to collect these taxes under the current laws, Clinton's second strategy might be to impose a "presumptive tax" of some sort, possibly a minimum levy on the total sales—rather than profits—of foreign companies in the U.S. But that kind of policy could backfire mightily. Germany has declared that if Clinton imposes such new taxation, Bonn will retaliate against local subsidiaries of American firms. With global trade tensions already at a fever pitch and foreign companies increasingly unhappy with conditions in the U.S., any further discouragement of outside capital might cause real harm to American economic growth. "Foreign investors have been very frustrated over the past two years," says Robert Hormats, vice chairman of Goldman Sachs International. "They're amazed that we're not dealing with the underlying problems of the economy, like the deficit and the educational system. They want to be reassured that we're going to fix them."

What foreign companies do not want is to pay a huge chunk of the bill for repairing these problems. Soaking the foreigners may have sounded to Clinton and his advisers like a politically painless program, but it could cost the U.S. a lot more in lost capital investment than it would gain in taxes. "Clinton is just going to have to rethink his policies on international taxation," says Garten. If Clinton does so, he will probably have to find the money elsewhere—or come to realize that his spending plan is too ambitious. ■

WSJ 9212140151
Headline: CEO'S ON THE SUMMIT: TAXING FOREIGN FIRMS WON'T WORK
By-line: Heiko H. Thieme
Source: Wall Street Journal
Date: Monday Dec 14, 1992 Sec: A p: 10
Length: Long 1088 words

Article Text:

Today President-elect Clinton sits down with economic advisers in Little Rock to plan the first Democratic administration in this country in 12 years. One of the ways Mr. Clinton promises to pay for his campaign promises to the average American is to widen tax enforcement on foreign corporations. For many reasons, this is a bad idea.

In his campaign, Mr. Clinton complained that foreign companies are not paying their fair share of taxes. He argued that stricter enforcement of tax laws already on the books would raise as much as $45 billion over the next four years -- or one-third of his total spending package. A quick analysis of tax revenues from foreign corporations suggests that the president-elect was selling an illusion. He was also -- and more importantly -- creating a time bomb for discouraging foreign corporations from doing business in the U.S.

Just last month, this newspaper provided some of the early public evidence on the problems with the tax proposal. It showed the U.S. liability of foreign-controlled domestic corporations totaled less than $6 billion in 1988, the latest year available. To assume that an extra $10 billion a year can be coaxed from foreign companies is dreaming. Mr. Clinton may plan to squeeze them further, but closer scrutiny of source-of-income, allocation-of-expense and transfer-pricing rules toward multinationals shows such efforts won't generate that kind of money.

Rather than trying to squeeze out an extra billion dollars or two by policing the internal activities of multinationals, the Clinton administration should focus on incentives to encourage foreign corporations to use the U.S. as their base.

Recent work by the Institute for International Economics shows that the American tax system has provided an environment increasingly hostile to high-tech production activities -- and to companies interested in basing in the U.S. The report, published in October, argues the cost could currently be as much as $34 billion annually in U.S. production. In my view the actual number could be much higher, for q10700,0009that figure does not include the cost of lost opportunity. The institute's director, C. Fred Bergsten, has been mentioned as a possible Clinton appointee. The hope is that Mr. Bergsten will advise the president-elect on this issue.

The U.S., of course, does have many advantages to work with. It has some of the lowest labor costs in the manufacturing sector among industrialized nations; productivity ranks high. Under the current tax structure, it is a natural choice for international corporations. Jobs will be among the foremost goals at the economic summit, and new corporations can provide them -- while strengthening the tax base at the same time.

A prime example of this is BMW's decision earlier this year to move production facilities from Bavaria to South Carolina. The more BMWs Mr. Clinton attracts, the stronger the U.S. economy. No matter how you do the math, the amount of direct taxes gained from corporations is much less important than the benefits derived from their activities and presence. Initial investments in research and development are also promising; companies do research, and then ild factories.

The issue for the summiteers therefore is not whether the U.S. should tolerate multinational corporations, but how to attract them. The rest of the world has the capital the U.S. needs to make its economy go. Attracting foreign multinationals is also helpful in the case of another bugaboo Mr. Clinton may

choose to worry about, the trade deficit. The more products the U.S. manufactures internally, the narrower the deficit. The basic corporate tax is also an issue here. It would be a major policy mistake for the new administration to surrender U.S. advantages through an ill-conceived tax hike at the corporate level.

If he raises taxes that hurt foreign multinationals, Mr. Clinton will find himself competing against countries that have lowered taxes for those companies. Some countries waiting to take U.S. business:

-- Ireland, which has for years enticed foreign corporations through extremely favorable tax treatment with the aim of creating jobs and revenues.

-- Switzerland, which keeps business through major tax incentives on investments of domestic and foreign corporations. (These incentives are so strong that many Swiss companies have stayed home despite record labor costs.)

-- Germany, which offers major incentives (a subsidy of as much as 50%, by some measures) to companies settling in eastern Germany. Without these incentives, the eastern German economy would have no chance to survive or compete. The irony of these incentives' success is that eastern Germany is -owing (from a small base), while western Germany is mired in recession.

Trade retaliation is also a danger under the likely Clinton program. One of the ideas floating around is to impose levies on foreign corporate revenues, rather than profits. The German government has already said that if these suggestions go into effect, subsidiaries of U.S. firms in Germany will be "punished" in the same way.

Speaking more generally, there is a way for Mr. Clinton to have his cake and eat it too -- to raise taxes on the rich, give relief to the middle class, and help the economy grow. It is to cut the capital gains tax to 15%. (Such a cut would work well only if the new tax law set a holding period of six months, or one year, rather than the onerous five-year period proposed.) Even though I am usually a supplysider, I would argue in this case that Mr. Clinton raise the top marginal rate on personal income to 36%, or even 40% -- but only if he lowers investment cost.

To stimulate and not to discourage should be the Clinton philosophy toward corporations and individual investors alike. The campaign is over; it's time to implement realistic policies.

Mr. Thieme is chairman and CEO of American Heritage Corp., a New York-based mutual fund.

International Herald Tribune, "ovember 31, 1992, Page One

Putting Tax Squeeze on Foreigners: Easy to Promise, Hard to Do

By Lawrence Malkin
International Herald Tribune

NEW YORK — In a search for new and politically risk-free revenue, Governor Bill Clinton has turned to foreign companies operating in the United States. Tax experts said Friday that unless a Clinton approach drastically improved on the methods already adopted in a Bush administration crackdown, the companies would have little to worry about.

On the stump, the Democratic presidential nominee has promised that by tightening enforcement, a Clinton administration would collect up to $45 billion in taxes from foreign-owned companies over four years. In 1988, the latest year for which figures are available, they totted up $825 billion in U.S. revenue but paid only $5.8 billion in taxes.

Prodded by a Democratic Congress, the Bush administration ordered the Internal Revenue Service to squeeze more revenue from international companies by close audits of the pricing policies between foreign parents and American subsidiaries. At present, 251 cases questioning these "transfer prices" are before the IRS's appeals board, with $13.6 billion in taxes at stake. Congressional estimates put the tax liability of foreign companies at $30 billion, a rough estimate.

Neither Mr. Clinton nor his staff have given any details of how they would collect more money. They rely on the statistic that 71 percent of these companies pay no taxes, while ignoring the fact that 59 percent of U.S. companies do not pay taxes, either. Many of the foreign subsidiaries are marketing companies set up to penetrate the United States with a foreign product that may take years to earn profits here.

Tom Field, a former Treasury Department tax attorney who edits Tax Notes, a trade publication, said: "These are the same ideas that have been kicking around for a long time. I guess the Clinton people have been talking to that same official the Republicans consulted — the one named Rosy Scenario — because if they get into office they will have to revise these hopeful campaign estimates downward."

If one case argued by Marc Levey of the accounting firm of Ernst & Young is any example, the estimates will have to be drastically reduced. Mr. Levey said his client, a large multinational facing a tax demand in the tens of millions of dollars, settled at a miniscule 1.5 percent of what the IRS wanted.

Mr. Field was not surprised, he said, because "settling for a penny and a half on the dollar is better for the IRS than losing the case in court."

A fair transfer price that can serve as a basis for taxation is set by comparing the company's practices with those of others in the field. Establishing this baseline price is very difficult, and arguing it out at a trial can be even harder because the standard of proof demanded by American courts is often impossibly high.

The IRS often uses industry-wide standards that do not apply; for example, trying to assess the earnings of French Champagne subsidiaries at the standard rates for U.S. beer and soft drink companies. Mr. Field recalls a case he lost in the 1960s for the IRS, which wanted to tax shippers of oil, grain and other bulk commodities whose hulls were registered in Liberia but owned by a Swiss company, where the trail went cold.

The government tried to establish its own independent valuations of shipping contracts, but its argument was rejected by the judge. As a result, Mr. Field said, tax collections of foreign shippers have suffered for years.

The IRS campaign has already had an effect abroad; tax authorities have started deciding that two can play this game. German tax law already makes it more difficult for German companies to load too much of their profit onto their offshore subsidiaries.

Mr. Levey said the French fisc had just proposed rules allowing its tax inspectors to conduct more detailed audits of the foreign subsidiaries of French companies. The Japanese are expected to follow other tax agencies, and Governor Clinton never points out that all of them can easily retaliate by being tougher on American companies in their own countries.

Attempts at reform of what is essentially an international area of fiscal anarchy have been under way for many years and the matter has been under occasional discussion at the Organization for Economic Cooperation and Development since the mid-1970s.

U.S. legislation has been introduced this year that would in effect set a minimum tax on the business done by international companies. Others have proposed arbitration.

Mr. Field proposes scrapping the whole system and going back to the method used in the 19th century by the states of the American union for national companies like railroads. It is called "formula allocation" and bases each state's tax assessments on the amount of property, the size of payroll, and the revenue from sales in that state.

"There are difficulties, but nothing like the near impossibility of proof under the comparable price system," Mr. Field said. Making the shift would probably demand agreement among America's major trading partners — not a quick or easy task.

Los Angeles Times, November 17, 1992, Page One

Doubts Greet Proposal to Dun Overseas Firms

By JUBE SHIVER Jr.
TIMES STAFF WRITER

WASHINGTON—One of the linchpins of President-elect Bill Clinton's economic revival plan—a proposal to extract billions of dollars in taxes from foreign companies doing business in the United States—is drawing skeptical reaction as evidence surfaces that current collection efforts are yielding small gains.

By closing loopholes and instituting more vigorous enforcement, Clinton has said he believes that the federal government can raise as much as $45 billion over four years from foreign companies, which take in nearly $1 trillion in revenue annually.

But while a number of foreign corporations pay little or no taxes in the United States, many experts believe that Clinton vastly overstates the possible revenue that can be gained from tougher enforcement of tax laws.

In addition, some economists worry that cracking down on foreign companies could lead to retaliation against U.S. firms doing business abroad. These experts note that the tax debate comes amid fast-rising tension between the United States and some of its trading partners.

In one high-profile case, Japan's Matsushita Electric Industrial Co., the nation's largest consumer electronics concern, said Tuesday that it has signed an agreement with the Internal Revenue Service. The settlement is one of a handful of accords that the agency has recently negotiated to try to ensure that foreign companies pay their fair share of U.S. taxes.

Most economists agree that many foreign companies camouflage their profits by manipulating the price of goods sold between overseas parents and their U.S. operations. They accomplish this mainly though "transfer pricing," the amount that a company charges its affiliates for products or services. When U.S. subsidiaries pay higher prices to the parent, their taxable U.S. income is reduced. But the profit of the overseas parent—which is exempt from U.S. taxes—rises accordingly.

But foreign companies have been successfully challenging Internal Revenue Service efforts to collect taxes allegedly lost to transfer pricing, some experts say. And others assert that even if foreign corporations paid the same tax rate as U.S. companies, the President-elect's arithmetic still doesn't add up.

"His projection of some $40 billion in tax collections from foreign companies seems wildly exaggerated," Jeffrey E. Garten, senior adviser to Blackstone Group, a New York investment firm, writes in the upcoming issue of Foreign Affairs quarterly. Garten, who is also a professor at Columbia University's Graduate School of Business, adds: "The President-elect should rethink his policies on this front."

In 1989, the U.S. Treasury reported that U.S.-owned companies paid 1.08% of their annual $7.8 trillion in revenue in corporate income tax. Foreign-controlled companies in the U.S. paid 0.64% of their $953 billion in revenue. If foreign corporations were to pay the same rate as U.S. firms, they would give the federal government about $16.8 billion over four years, about $28 billion short of Clinton's projections.

Another government study reportedly found that the IRS had only limited success in recovering additional taxes in transfer pricing cases involving foreign companies that had appealed their cases with the agency. From 1987 through 1989, the government got only 26.5% of the $757 million it sought.

"I don't think we are dealing with foreign companies that are tax cheats," said Aaron Rubinstein, a partner at the New York-based accounting firm KPMG Peat Marwick, which has prepared a study on the issue.

Like many tax experts, Rubinstein contends that most foreign corporations doing business in the United States already pay higher tax rates in their own country than they do here. Thus, he asks, "Why would a company coming from a high tax jurisdiction shift [profits there] from a relatively low tax jurisdiction" such as the United States? "It's a zero-sum game."

While the transfer-pricing debate rages, the IRS has proposed several new regulations aimed at wresting more taxes from foreign companies, including a plan that would restrict the ability of foreign banks to take an interest deduction for its U.S. real estate loans.

But the tax efforts have touched off a firestorm of criticism.

Britain's ambassador has reportedly complained to Clinton aides that U.S. taxes paid by British firms are proportionately more than the amount U.S. firms pay in Britain.

The taxation director of Barclays Bank flew to the United States late last month to personally complain to IRS officials that "an increasingly hostile tax environment is at least one cause for [the] gathering withdrawal of British banks from the U.S." The official, David Elvidge, noted that U.S. operations of British banks have assets of $56 billion and employ 7,250 people.

"This dispute is likely to exacerbate relations with companies and foreign countries at a time when we are still very dependent on investment from abroad," said William Nifkanen, chairman of the CATO Institute, a policy research group in Washington. "The only conditions under which it pays for a foreign corporation to shift their taxes to their home country is when their own tax rates are lower than the U.S., and that's a very rare occurrence."

DOCUMENT= 2 OF 5 PAGE = 1 OF 6
ACCESS # 921112-0088.
HEADLINE Taxing the Foreigner Means Taxing Us

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* By Barbara N. McLennan
LENGTH ESTIMATED INFORMATION UNITS: 8.6 WORDS: 1043
DATE 11/12/92
SOURCE WALL STREET JOURNAL (J), PAGE A14

The economic plans that won Bill Clinton the presidency include a
* program to raise business taxes by $58 billion over the next four years. That program, in its early forms, depended heavily on collection of an estimated $45 billion in additional tax revenue
* from foreign corporations doing business in the U.S. The specifics of Mr. Clinton's proposal are likely to change – perhaps he will discuss them with the other wise men who attend his economic summit.
* But whatever the shape of the final foreign tax proposal, the president-elect might like to consider another side of the same policy: its costs to our own economy.

* Historically, U.S. earnings of corporations, whether foreign or domestic, generally have been treated equally under U.S. tax law. We have entered into treaties to ensure equitable tax treatment across international boundaries, as well as to protect U.S. citizens and businesses from double taxation.

Now Mr. Clinton apparently seeks to exact harsh enforcement of the tax law with respect to certain corporations just because they happen to be owned by investors from other countries. The owners may not vote in U.S. elections, but their customers, employees and suppliers do. In our increasingly global economy this is a large and growing population.

* Tax enforcement that singles out foreign businesses operating in the U.S. will attack a segment of the U.S. economy that has created many jobs and shown impressive productivity growth over the past several years. In 1988, 3.8 million U.S. workers were employed by foreign-owned firms. In two years, the number increased by more than
* 22%. In 1990, non-bank U.S. affiliates of foreign companies employed more than 4.7 million Americans. They accounted for nearly 5% of employment by businesses in the U.S.

Workers in foreign-owned companies are not particularly low-skilled or concentrated in menial service occupations. Nearly half of these workers hold jobs in various manufacturing industries; a quarter are in wholesale and retail trade. In 1988, compensation
* of workers in manufacturing firms owned by foreign affiliates averaged $33,700 a year; in that year, the average annual compensation of U.S. workers employed by U.S. parent companies in

all industries was $32,900. In 1989, hourly earnings of workers employed by U.S. affiliates of Japanese firms in 25 major manufacturing industries averaged $11.52; this was nearly 10% higher than the comparable average wage for all of U.S. manufacturing that year.

Foreign-owned affiliates are located throughout the U.S., but with higher concentrations of employees in some regions than others. For example, in 1990, 14% of Delaware's employees had jobs with foreign-owned affiliates, nearly three times the national average. Other states with a higher-than-average proportion of foreign-affiliate employees include Hawaii, South Carolina, Alaska, New Jersey, West Virginia, North Carolina, Georgia, Maine and New Hampshire. The states with the largest numbers of workers employed by foreign firms are California, New York, Illinois, Pennsylvania and Ohio. Each of those five states has more than 200,000 employees working for foreign-affiliated businesses.

Foreign companies that invest in the U.S. make direct contributions to the economic health of this country. Between 1977 and 1988, these companies doubled their contribution to U.S. gross output, sales, and research and development expenditures. In this period, the gross product of U.S. affiliates of foreign companies grew nearly four times as fast as did all U.S. manufacturing establishments.

The increase in manufacturing output probably reflects the foreign-owned affiliates' relatively greater degree of investment in technology when compared with all U.S. manufacturers. These companies doubled their payments for royalties and license fees between 1986 and 1989, and spent more on R&D per dollar of gross product than did domestic manufacturers. In 1987, foreign affiliates spent 7.6% of gross output on R&D, compared with 6.5% for domestic companies.

By world standards, the U.S. has been and remains the single largest recipient of foreign direct investment. At the end of 1990, the U.S. inward stock of investment was almost $400 billion, nearly double that of the second largest host country (the United Kingdom). However, in terms of the proportion of the world stock of private investment, the U.S. share declined to 24.2% of total world outward investment in 1990 from 26.8% in 1989. Europe and Japan have increased their proportional shares.

Targeting tax enforcement on foreign investors, because they are foreign, will burden a part of the economy that has been a source of employment and productivity gains. It may accelerate the recent trend of foreign investors to look outside the U.S. for investment opportunities. It also will signal a departure from traditional notions of equity and impartiality in tax policy, and will clearly be an invitation to retaliation from our main tax treaty partners.

These countries undoubtedly would like to receive more revenue from U.S. companies operating in their jurisdictions.

It is well to consider who will actually be paying the price of these new tax policies. The Clinton proposal can be applied only to income subject to U.S. tax laws – that is, income somehow connected to the U.S. Most of this income will accrue to foreign-owned companies located in the U.S. that sell their products and services here. Since corporations in the U.S. always have the option of raising prices to cover costs, much of the actual incidence of the new taxes most likely will fall on U.S. consumers.

Rising costs due to increased taxes presumably will affect sales and profits, and may well induce some foreign companies to cut back their operations in the U.S. They can do this by reducing their purchases from suppliers, most of which will be other U.S. businesses. They can also lay off current workers or decide not to expand as rapidly, postponing the hiring of new workers.

Workers, communities, businesses and consumers in the U.S. will be paying the price of the increased taxes, not the proverbial "man behind the tree." Mr. Clinton, of course, needs revenue from somewhere to support his programs. Not having a clear statement of principle as to who should be taxed and why, he reverts to prejudice. In this case, the enemy is not just the "foreigner." The enemy is all the people who buy from, work for, serve and supply foreign-owned U.S. companies; the enemy is us.

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Ms. McLennan, an attorney in McLean, Va., specializes in international tax law.

End of Story Reached

Wall Street Journal, November 11, 1992, Page A12

Clinton's Economic Proposal Faces Problem: Taxes of Foreign Companies Won't Meet Goal

By Rick Wartzman
Staff Reporter of The Wall Street Journal

WASHINGTON – The Internal Revenue Service's limited success in squeezing additional tax dollars from foreign corporations has raised serious doubts about one of the critical underpinnings of President-elect Bill Clinton's economic plan.

Mr. Clinton has said he can raise as much as $45 billion over four years by more vigorously enforcing the tax laws against foreign companies. But the IRS began such an enforcement effort several years ago, and its poor success rate to date suggests that Mr. Clinton may find it impossible to come even close to his goal.

"There is no way, no chance, none, zero that you are going to get $45 billion," Fred Goldberg, the Treasury Department's assistant secretary for tax policy, told a group of tax experts in San Diego earlier this week. "The money is just not there."

IRS's Efforts Cited

To be sure, the IRS has tried. Just yesterday, Matsushita Electric Industrial Co. said it had signed a pricing agreement with the IRS – one of a handful of such accords recently negotiated by the tax collector to try and ensure foreign companies pay their fair share. The IRS also has proposed new regulations that conceivably could help the government wrest more in taxes from foreign-owned companies.

But so far, such efforts have yielded relatively little. Even supporters of Mr. Clinton's pledge to be tougher on foreign companies doubt that he can come up with all the money he says he can, given the IRS's track record in this area. "I don't think he's going to get anywhere near $10 billion a year," says James Wheeler, a professor of accounting at the University of Michigan's business school.

The issue is critically important for Gov. Clinton, who ambitiously promised during the election campaign that he would institute a number of costly new programs, bring down the budget deficit and cut taxes for the middle class, all at the same time. In campaign appearances, the Arkansas governor repeatedly said that to do this, he would have to raise taxes only on wealthy people and foreign corporations.

The $45 billion he said he would raise from foreign corporations accounts for about 33% of his total increase in taxes. If that money fails to materialize, it will greatly increase pressure on the new president to either sharply reduce his spending programs, increase the deficit, or raise other taxes.

Mr. Clinton's plans rest largely on tapping into an area known as "transfer pricing," which refers to the amount that a company charges its affiliates for products or services.

The standard for such exchanges is, on its face, simple enough: The transfer price is supposed to be "arm's length" – that is, the same price at which the product would have been sold to an unrelated, third-party buyer. But by manipulating the price of goods sold between an overseas parent and its domestic operations, a company can artificially decrease the amount of income it earns on U.S. soil and lower its tax burden to Uncle Sam.

Foreign Companies' Taxes

[illegible]

	NET INCOME (BILLIONS)	TAXES (BILLIONS)
1983	$1.8	$3.4
1984	4.5	4.5
1985	3.8	3.8
1986	(1.5)	5.8
1987	5.6	4.8
1988	11.2	5.8

Note: [illegible]

Source: [illegible]

When it suspects such an abuse, the IRS tries to go in and collect the difference. But companies – both U.S. and foreign-owned – have been challenging the IRS, and defeating the agency time and again.

A study completed in June by the General Accounting Office, for example, found that of the transfer-pricing cases involving foreign companies that went through the IRS's internal appeals process from fiscal 1987 through 1989, the government came away with only 26.5% of the total $757 million it was seeking. The GAO further found that in cases involving seven of the eight foreign companies with the largest proposed transfer-pricing adjustments, the IRS won less than 15% of what it contended it was owed.

"We have not done well on these cases," acknowledges Ellen Murphy, an aide to IRS Commissioner Shirley Peterson.

When matters have gone as far as the courtroom, the results also have been running against the government. In fact, the two big transfer-pricing cases litigated most recently, involving Merck & Co. and a Nestle S.A. unit, were decided completely in the taxpayers' favor.

Even in earlier cases, where the court found the government's position more compelling, companies "have been able to persuade the judges that if their transfer prices weren't correct, they've been nowhere near as wrong as the IRS has contended," says Philip Morrison, who served as the Treasury Department's international tax counsel until June. Now, he is a partner in Washington with the law firm of Baker & McKenzie. In light of that, he adds, "you have to ask yourself" how a Clinton administration could suddenly expect to fare much better.

That's especially true given that Mr. Clinton's advisers have indicated privately that the president-elect doesn't intend to put new transfer-pricing laws or regulations into place. Mr. Wheeler believes that without an overhaul of the rules on the books, the IRS isn't likely to be more successful in transfer-pricing cases, even if Mr. Clinton throws more resources at the problem. For his part, Mr. Goldberg says hiring more IRS examiners for transfer-pricing cases would actually cause the government to lose money for three years while they were being trained.

Widespread Cheating Suspected

Mr. Clinton's promise to start "cracking down on foreign companies that prosper here and manipulate tax laws to their advantage" has been a source of controversy ever since his economic blueprint was first published in June. Some lawmakers and a few academics say they have little doubt that a tremendous amount of cheating by foreign corporations goes on – even far more than Mr. Clinton thinks.

But many more economists say the $45 billion figure is greatly overblown. Ms. Peterson, the IRS commissioner, told a House panel earlier this year that the "tax gap" from transfer-pricing abuses by foreign companies is, at most, about $3 billion a year. She also asked that certain tools Congress has given the IRS in recent years to combat the problem be given adequate time to work.

The Economist, November 7, 1992, Page 39

Taxing the rich

NEW YORK

FOREIGN companies do not vote in presidential elections. So, when the Democrats needed to propose at least one hefty tax increase to make their campaign promises more fiscally respectable, guess who made an easy target. Now Bill Clinton has won, the target can probably relax.

Finding a pretext for stiffer taxation of foreign companies was not hard: accountants toil day and night to help treasurers book profits where tax rates are lowest, and that does not mean America. Clamping down on such abuses of transfer pricing, claimed Mr Clinton, might be worth extra tax revenues of $45 billion over four years. Members of the House of Representatives' Ways and Means Committee began bandying round an even higher estimate during the summer. But by then the Internal Revenue Service (IRS) had already come up with much lower figures of its own.

It found that, as is often alleged, foreign-controlled companies typically show a lower return on assets than American companies (about 0.6% compared with 2.9%). Even assuming that as much as half of the difference reflects the shifting of profits through transfer pricing (as opposed, say, to a greater proportion of expensive new assets on which returns must be earned), and assuming that all of this could be identified and disallowed, the IRS suggested a yearly revenue boost of $3 billion might be something of a coup. That would compare with a total tax bill of $5.8 billion paid by foreign-owned American companies in 1988, the latest year for which published returns are available.

They'll need the foreigners

The Clinton White House looks unlikely to push for anything more ambitious. Many foreign companies are job-creators: harsher taxes might discourage them, as well as provoking retaliation against American companies overseas.

A government keen to be seen boosting the jobs market and encouraging growth ought to be a government strongly in favour of inward investment. Whether this will help British Airways to buy into USAir, the country's fourth-largest airline, is harder to say. The three big American carriers, who oppose the deal, hope Mr Clinton will block it. But he has hedged his public position so carefully that others are not so sure. (Formal talks on the regulatory background to the deal resume on November 10th.)

Nowhere, though, have Mr Clinton's skills at obfuscation been more apparent than in trade. Here ought to lie the biggest plus for foreign companies operating in America: they could soon find themselves inside the North American Free Trade Area. The leading business champions of NAFTA—bosses like American Express's James Robinson and Eastman Kodak's Kay Whitmore—are confident that Mr Clinton is a strong NAFTA man. But first Mr Clinton will need to make clear that he, and not the new Congress, is in charge of trade policy.

National Review, November 2, 1992, Page 14

Taxing the Golden Goose

IN HIS enterprising search for new tax revenues, Bill Clinton has stumbled upon a $30-billion gift from Dan Rostenkowski. That is the House Ways and Means Committee's estimate of the extent to which foreign corporations "cheat" on their U.S. taxes.

Mr. Clinton has swallowed the idea that foreign firms routinely "overcharge" their U.S. subsidiaries for parts shipped from home base in order to reduce their reported earnings. Never mind that the IRS has conducted extensive audits of foreign firms and come up dry. Or that such abuses, if they did exist, would merely shift profits to the home country, where tax rates are generally higher.

Tax "fairness," in Clinton's view, requires *assuming* that foreign companies earn money on their U.S. operations at 75 per cent of the rate earned by their U.S. competitors. If, for example, U.S. computer manufacturers averaged a 10 per cent profit on sales, a foreign computer maker selling $100,000 worth of computers would be forced to declare profits of at least $7,500, whether the company actually made money or not.

But Governor Clinton balances his attack on foreign investment with an attack on U.S. investment abroad. Foreign subsidiaries of U.S. firms would no longer be allowed to defer taxes on foreign profits that are reinvested. Mr. Clinton apparently thinks that the best way to keep U.S. capital in the U.S. is to limit profit opportunities abroad rather than increase opportunities at home. Messrs. Smoot and Hawley would have agreed.

The U.S. economy benefited from a record inflow of foreign capital during the Eighties; millions of Americans owe their jobs to foreign entrepreneurs. Profit rates for foreign-owned operations in the U.S. are indeed lower than for comparable domestic investment, but this reflects the enormous costs of starting operations in a foreign country—not tax cheating.

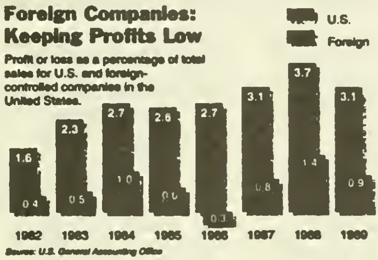
The Clinton people know all this. Their "plan" for foreign investment is protectionism, pure and simple. But it is hard to see which special-interest groups will benefit. Not American-owned operations abroad, which would rightly fear retaliation; and not the about-to-be-unemployed Americans currently working for foreign companies.

New York Times, October 24, 1992, Page A9

Corporate Taxes

Clinton Seeks Taxes on Hidden Profits

By JOHN H. CUSHMAN Jr.
Special to The New York Times



WASHINGTON, Oct. 23 — Gov. Bill Clinton's proposal to collect billions of dollars in taxes owed by foreign-controlled companies would tap into one of the richest, but also one of the most elusive, potential sources of new revenue available to the Government.

By aggressively enforcing existing tax laws, the Democrat would stop international corporations from avoiding taxes by shifting their profits overseas. He says he could raise $45 billion this way in four years. If his figure is wrong, one of the pillars of his plan to cut the Federal deficit will be seriously undermined.

Mr. Clinton's proposal is central to his dispute with President Bush over whether a Clinton Administration would have to raise income taxes on middle-income voters. Mr. Clinton says much of the revenue he plans to collect would come from corporations.

Shifting Profits Overseas

At issue is a device used by companies that operate both in the United States and abroad. By paying inflated prices for products purchased from its overseas unit, a domestic company can artificially inflate its costs in the United States, which keeps its profits — and therefore its taxes — in this country to a minimum.

Under international tax rules this is illegal. Even related companies are supposed to price their transactions as if they were unrelated. But it is not easy for tax auditors to prove violations.

The Clinton campaign points out that in 1988, foreign-controlled domestic corporations took in $825.6 billion in receipts but kept profits low enough that they paid only $5.8 billion in taxes. Mr. Clinton's program promises to increase the tax collections from these companies by $45 billion over a four-year period.

His advisers say that that is a relatively modest target and that they seek only to collect what is due under existing laws.

Critics, including Bush Administration officials, argue that Mr. Clinton's goal is too ambitious and that collecting more taxes would discourage foreign investment in the United States. But it is hard for the Administration to criticize Mr. Clinton's proposal too strongly, since the Internal Revenue Service is already pushing hard to collect more of these taxes.

States, Too, Would Benefit

Even before it became a matter of Presidential politics, the problem vexed tax officials seeking better enforcement methods. Legislation introduced this year proposed, in effect, to set a minimum tax on the business done by international companies. And the Internal Revenue Service has proposed regulations addressing how intangibles like software should be priced.

Both the legislation and the regulations have met with resistance from foreign nations and from companies that favor the status quo. But other new approaches, like arbitration, are getting favorable reaction.

Meanwhile, some aspects of the Clinton program are rarely if ever mentioned: that it would presumably also increase tax collections on American companies that use the same trick to shield profits from taxation, and that the states, too, would reap billions of dollars if the plan was carried through.

Many tax experts believe that Mr. Clinton is onto an important idea, although the exact amount he claims could be collected cannot be confirmed.

The current system of enforcing the tax laws "is close to being broke," said Gary C. Hufbauer, a tax expert at the Institute for International Economics. "And there is growing revenue in them hills."

Could Affect U.S. Companies

Even if Mr. Clinton exaggerates the amount to be collected from foreign companies doing business in the United States, the same tax scheme is often used by American companies shifting profits to overseas subsidiaries, and if the crackdown extends to them, the Clinton campaign's revenue target might well be achievable.

A plan to get more tax revenue out of foreign companies.

Because tax avoidance is by definition hidden, it is exceptionally difficult to estimate how much money might be available from foreign-owned companies. The range of estimates runs from $3 billion a year to $30 billion, with the Clinton proposal assuming that the truth lies somewhere in the middle.

'Huge Amounts of Money'

The President has repeatedly said Mr. Clinton plans to increase taxes by $150 billion over four years, an amount that Mr. Bush says could hardly be collected by taxing only wealthy individuals. In fact, the Clinton economic plan proposes to collect $91.7 billion from wealthy individuals, plus $58.3 billion by "closing corporate loopholes," including tax avoidance by foreign-owned companies.

Though enforcing tax laws on corporations would seem to be a politically appealing policy, the Clinton camp has evidently decided to focus its campaign promises on foreign companies, whose owners have less political clout.

Many states base their corporate taxes on how much a company owes the Federal Government. If it is true that foreign-owned companies are avoiding $30 billion a year in Federal taxes, the states are probably missing out on $7 billion a year — more than the annual Federal aid to the states for mass transit programs.

"This is probably the largest single fiscal problem in the United States," said Dan Bucks, executive director of the Multistate Tax Commission, a nonpartisan organization of 19 state tax agencies. "I don't know of any other issue that involves such huge amounts of money."

The $30 billion estimate, first published by the House Ways and Means Committee, is described by a committee staff member as a reliable "ballpark" figure. It was based on testimony by an I.R.S. official who had analyzed data on profits of international companies. The sampling showed that foreign-controlled companies consistently reported far less profit than domestic companies engaged in comparable businesses. The official calculated what tax would be owed if profits were comparable.

Widely Accepted Estimate

Not only Congressional Democrats, but many Republican lawmakers, including Senator Jesse Helms of North Carolina, Representative Duncan Hunter of California, and Senator Alfonse M. D'Amato of New York, have accepted the $30 billion figure.

Subsequent studies by scholars and accountants have suggested that the lower profits reported by foreign companies are due largely to "innocent" factors like exchange rate fluctuations, efforts to increase market share and differences in the historical accounting for depreciation of assets.

Even so, Tax Notes International, a respected trade publication, reported that the United States Tax Court is currently considering disputes in which the I.R.S. is claiming that United States and foreign companies owe $32 billion because of improper profit shifting.

And in 1989 alone, the I.R.S. proposed tax adjustments of $500 million against foreign companies and $4 billion against American companies for this kind of tax avoidance.

New York Times, October 23, 1992, Page A21

THE AD CAMPAIGN

Clinton: Attacking Policy on Foreign Businesses

The Clinton campaign began broadcasting this 30-second commercial in select markets yesterday. The campaign refused to give specifics about where it will appear.

ON THE SCREEN Opens with black letters on a white screen as the announcer says, "This is the $825 billion question."

Cuts to video of foreign cars rolling off the boat after shipment. These words appear on bottom of the screen: "Foreign corporations in U.S. took in $825 billion. IRS Bulletin, 4/8/92."

Cuts to dime rolling. Cuts to video of President Bush speaking, with these words superimposed: "Supports tax loopholes for foreign companies here," then, "Attacks Bill Clinton for wanting to close them. Bush speech, 8/27/92."

Warm images of Mr. Clinton and Senator Al Gore.

White letters on a black background: "Clinton/Gore. For People. For a Change."

TELEVISION SCRIPT Announcer: "This is the 825 billion dollar question. That's how much foreign corporations operating in the U.S. took in one year. But 72 percent of them didn't pay a dime in taxes.

"Not one dime. And George Bush supports tax loopholes for foreign companies operating here. Supports them so much that he attacks Bill Clinton for wanting to close them.

"Bill Clinton wants to collect what foreign corporations owe and put the money to work to rebuild America.

"Clinton/Gore. For people, for a change."

ACCURACY Raw figures cited are accurate. Bush campaign contends that many foreign corporations did not pay taxes because they did not make a profit. But Democrats counter that foreign companies would not operate here if they were not somehow benefiting financially. The ad also does not reflect the

Republicans' position that international investment and open markets are in this country's best interest. What the Clinton campaign calls "loopholes" the Bush campaign describes as "tax incentives."

SCORECARD As the Clinton campaign emphasizes the sour economy as the main issue in this election, the image of foreigners not paying their fair share is a powerful one. Republicans attack the ads as playing on xenophobia in the electorate.

RICHARD L. BERKE

The Christian Science Monitor, October 23, 1992, Page One

Small Firms Not Thrilled By Clinton's Philosophy

But some fault Bush for disengagement on domestic policy

By Amy Kaslow
Staff Writer of the Christian Science Monitor

LITTLE ROCK, ARK.

STRATEGISTS at the Clinton-Gore campaign headquarters are very proud to call Bill Clinton a pro-business Democrat, a label that has long been a contradiction in terms for presidential politics.

Gene Sperling, the campaign's economic policy director, runs down a list of new endorsements from Fortune 500 leaders and from high-tech business leaders who support the Clinton-Gore economic strategy.

But Governor Clinton has yet to win over smaller United States firms, which account for well over half of US employment and output. Moreover, these small companies have been responsible for the lion's share of job creation over the last decade. Wary of being targeted by more taxes and regulations, these businesses are uneasy about what a Democratic administration would bring.

William Dunkelberg, chief economist of the National Federation of Independent Business (NFIB), has no doubt that, under a Clinton administration, businesses will be hit with a host of new government-mandated costs that eat into their bottom lines. Eighty percent of NFIB's 600,000 members have less than 40 employees. "Absolutely, there will be more regulations if Clinton wins," says Mr. Dunkelberg, who is also dean of Temple University Business School.

If Clinton occupies the White House, "Congress will be heaping on the mandates – from health care to day care, to elderly care, to care for the environment," he asserts.

The critical difference between Clinton and President Bush, Dunkelberg says, is that "Bush has used the veto 30-odd times, and Clinton won't."

All the costs that businesses incur from government regulations will more than offset Clinton's proposed business tax breaks that are designed to create jobs, he adds.

"I call it 'sneak a tax on business,'" says conservative John Cregan, president of the US Business and Industrial Council. "Because government can't afford to pay for social costs, due to its $400 billion deficit, it tries to make business foot the bill."

Mr. Cregan says his members are unhappy with both candidates. "They feel burned by Bush," who signaled both the Environmental Protection Agency and Congress that his administration "was a kinder and gentler time for regulations," says Cregan. He applauds Clinton's "very hands-on approach" in promoting US competitiveness.

And while he differs with much of it, Cregan is also impressed with the amount of work Clinton has put into "his detailed economic plan."

William Dunkelberg, chief economist of the National Federation of Independent Business, says that if Clinton wins, 'there will be more regulations.'

By contrast, he says, Bush is "so disengaged, he obviously doesn't care about domestic policy."

But "the pillars of Clinton's 'putting people first' plan," says Cregan, foist too much government on the private sector. "Clinton says companies must provide for an employee's social welfare; if they refuse, they must pay a tax so the government can be the provider."

Such mandated benefits and increases in the payroll tax, says Cregan, "are prohibitive for small firms and start-ups," which have generated roughly two-thirds of the nation's job growth during the past decade.

Big corporations already offer health care and family and medical leave, says Cregan, "and now they want the government to force the smaller companies to absorb some of the costs."

Foreign corporations are also anxious about a Clinton victory; the Democratic nominee has pledged to raise revenue by imposing a tax on international firms investing in the US.

Roberto Albisetti, the Washington director of IRI, a huge Italian conglomerate that employs 8,000 Americans in the US alone, says his firm is one of many large European concerns that have invested in the US as part of a global production, technology, and market network. These foreign investors provide the high-skill, high-wage jobs that Clinton seeks for more US workers.

While Clinton's proposal is designed to tax the income of foreign firms that is hidden by creative accounting or by establishing holding companies in offshore tax havens, Dunkelberg says "the true masters of those schemes are US firms.

"We are by far the biggest foreign investors in the world. If we impose a tax like that, our investors will be slapped with the same tax by foreign governments."

Conspicuously missing from the election-year debate is a serious discussion of the burgeoning federal deficit and a government commitment to spend within its means, Dunkelberg says. "In every election, the presidential candidates have offered plausible plans. That's where we need leadership. This year, everyone's ducking it."

Business, driven by consumer demand and investment capital, is troubled by lack of fiscal responsibility. Given the economic uncertainty, manufacturers keep production and orders to a minimum so they are not saddled with large stocks and debts.

Dunkelberg, who prepares monthly forecasts of business confidence, says: "We're looking at the leanest inventory picture in the history of our surveys, which we started in 1973. The only thing lower than the stock of inventory is the stock of consumers, and business hiring plans are very weak."

The Christian Science Monitor, October 2, 1992, Page One

DEFICIT PROSPECTS

Clinton Tax Idea May Not Produce Expected Funds

By Ron Scherer

Staff writer of The Christian Science Monitor

NEW YORK

FOR months Arkansas Gov. Bill Clinton has been saying he wants to hike taxes on the United States subsidiaries of foreign corporations, raising $45 billion over the next four years.

However, there are considerable doubts whether that much money can be expected.

"It seems to me almost certain that figure of $45 billion is exaggerated," says Thomas Field, executive director of Tax Analysts, a nonprofit publisher of tax materials in Arlington, Va.

US Treasury numbers raise further doubts. In 1989, the Treasury reports, US-owned corporations paid 1.08 percent of their total $7.8 trillion revenues in corporate income tax. Foreign-controlled corporations in the US paid 0.64 percent of their total $953 billion revenues. If foreign corporations were to pay the same rate as US companies, they would give Uncle Sam another $4.2 billion per year, or $16.8 billion over four years. This is $28 billion short of Governor Clinton's projections.

Gene Sperling, Clinton's chief economic policy adviser, says the campaign continues to believe it can raise $10 billion per year. Mr. Sperling says the Clinton numbers were derived from looking at the tax rates of different industries, the success rate of Internal Revenue Service (IRS) claims, and the amount of taxes US companies pay abroad. He says estimates of potential new revenues from foreign firms ranged from $3 billion to $30 billion per year.

If the IRS did not get that much money, "we might have to find other spending cuts or scale back spending," he concedes.

The Treasury numbers surprised another Clinton adviser, Robert Shapiro of the Progressive Policy Institute. Mr. Shapiro, an

architect of the Clinton economic plan, says that if the US Treasury statistics are right, "they suggest we ought to be looking at more serious tax reform." In other words, higher business taxes.

Sperling denies any such intention. "We are not considering any corporate tax reforms, and I speak on behalf.of the campaign when I say that," he says.

"It is quite clear they have made a horrible estimating error and will have to find their way out of it," says retired Rep. Bill Frenzel (R) of Minnesota, now a fellow at the nonprofit Tax Foundation in Washington.

THE Clinton forces gathered their ammunition from a hearing held last spring by the Subcommittee on Oversight of the House Ways and Means Committee. According to the chairman, Rep. J. J. Pickle (D) of Texas, more than 70 percent of the 46,000 foreign corporations operating in the US do not pay taxes. Mr. Pickle's staff singled out 36 foreign-controlled automobile, motorcycle, and electronics distributors. The congressional staff found that over 10 years the companies had US sales of $350 billion but paid only $4.6 billion in taxes.

Pickle was amazed to find that 28 percent of the automobile distributors, with sales of $27 billion, did not pay any tax.

Testifying at the same hearing, IRS Commissioner Shirley Peterson said that in 1989 only 28 percent of all foreign corporations reported income tax, while 41 percent of US-owned companies paid income taxes. "We believe there is a compliance problem ... but we cannot quantify it."

The IRS faces a host of challenges. It sometimes has difficulty getting cooperation from foreign governments when auditing parent companies abroad. It also has trouble getting and keeping skilled international auditors.

There are other reasons why foreign companies don't pay the same tax rate as US companies. Foreign companies often have higher debt levels than US companies. Interest on this debt is a deductible expense. Because they have newer facilities, they have higher depreciation allowances.

However, the IRS says 50 percent of its examinations focus on accounting justifying the price a foreign parent company charges a US subsidiary or distributor for imported parts or products. If a company wants to transfer its profits offshore – perhaps to a lower-tax country – it charges a lot for the goods, including the cost of manufacturing, research and development, advertising, parent-company overhead, insurance, and other fees.

The IRS has been tightening the regulations on such "transfer pricing." In 1989, the IRS imposed new record-keeping requirements. Since then, the IRS has increased audits of foreign-controlled corporations by 127 percent and increased the number of international auditors by 100. It is auditing the top 200 foreign-controlled corporations.

The IRS estimates that it requires major adjustments for 75 to 100 foreign-controlled companies per year on this issue. However, the Tax Court has only sustained 23 percent of those adjustments.

Recently, the IRS proposed new rules under which it would be able to calculate a profit for a foreign-owned company based on its industry. "Understandably this has our foreign trading partners upset," says Bruce Garrison, a tax lawyer at Haight, Gardner, Poor & Havens in New York. He says some companies are already beginning defensive tax planning.

The Washington Post, October 1, 1992, Page A12

Bush, Clinton Bring Obscure Tax Issue To Forefront in Their Stump Sparring

Candidates Disagree Over Cracking Down on Foreign-Owned Firms

By Daniel Southerland
Washington Post Staff Writer

The taxation of foreign corporations might seem an issue more for Washington lawyers and accountants than for plain-talking politicians on the stump.

But in recent days, the question of whether the Internal Revenue Service should crack down on foreign multinational firms that may be avoiding taxes in the United States has set Arkansas Gov. Bill Clinton and President Bush to sparring on the campaign trail.

Bush charged in a speech last Saturday in Marysville, Ohio, that Clinton wanted to "slap a tough tax" on foreign factories in the United States, including the Honda automobile plant in Marysville. Clinton in a speech on Tuesday in Louisville said Bush wanted to make the United States a "tax haven" for foreign-owned businesses.

Clinton has proposed collecting billions of dollars of additional corporate taxes from foreign-owned companies here.

Bush charges that Clinton is trying to create a new tax on foreign investors that would cause foreign governments to retaliate against American companies on their soil, cost the jobs of U.S. workers in foreign-owned plants and reduce foreign investment here.

Clinton has made additional tax collections from multinational companies a major part of his economic program, contending that by 1996 he could bring in $13.5 billion a year in new revenue simply by tightening tax enforcement. The projected new revenue would be a key part of Clinton's plans to reduce the federal budget deficit. Bush has taken up the issue as a way of portraying Clinton as a protectionist opposed to free trade.

Independent analysts in the government, financial institutions and research institutes say Clinton has locked on to an important issue but overstates the possible revenue to be gained. At the same time, they say, Clinton is ignoring the fact that U.S. multinational firms engage in some of the same tax avoidance practices as foreign-owned firms.

Bush, the analysts say, vastly overstates the threat of foreign retaliation and distorts Clinton's position by contending that it amounts to a tax increase.

The issue is not a new one. In 1990, Congress broadened special powers it had given the IRS in 1989 to inspect the books of U.S. subsidiaries of foreign companies, penalize the companies and gather more documents from them. The IRS has added more economists to deal with the issue.

The IRS has for several years been examining hundreds of foreign-owned corporations for evidence of possible tax avoidance.

But it is widely recognized that the IRS is "out-gunned" when it comes to having lawyers to deal with the issue. Foreign-owned corporations subject to audits can hire the best tax attorneys to defend them and have even hired away from the IRS some lawyers specializing in the issue.

The IRS recently lost a major battle to collect taxes from Westreco Inc., a subsidiary of Nestle SA of Switzerland. A U.S. Tax Court judge here rejected the IRS's claims that the subsidiary owed $8.8 million in taxes. Two of the defendant's lawyers had worked for the IRS.

According to tax experts, the most widespread form of tax avoidance results from a practice known as "transfer pricing." Corporations wishing to avoid U.S. taxes use their internal bookkeeping to improperly transfer overseas the profits they make in the United States. The home companies inflate the prices they charge their U.S. subsidiaries for products, materials and services.

The experts say it is difficult to uncover such transfer pricing and estimate the amount of tax avoidance unless the corporation cooperates with auditors and gives them access to records overseas, often in foreign languages.

One financial policy analyst who has studied the issue said, "Clinton can raise some revenue, but if he really wants to solve the transfer pricing problem, he will also have to look at U.S. multinational corporations that are avoiding taxes.

"There are many ways to shelter income, and U.S. multinationals can shelter their overseas profits as well," said the analyst.

A bill introduced earlier this year by Rep. Dan Rostenkowski (D-Ill.), chairman of the House Ways and Means Committee, and Rep. Willis D. Gradison Jr. (R-Ohio) sets a minimum level of taxable income to be reported by foreign-controlled corporations. Clinton has not endorsed the bill but calls for firmer tax enforcement.

The legislation would require foreign-owned businesses to report an amount equal to at least 75 percent of what U.S. companies in the same industry report.

U.S. companies generally pay higher taxes in the United States than their foreign counterparts.

Rep. J.J. Pickle (D-Tex.) calculates that the United States is being cheated out of $20 billion to $30 billion a year by foreign-owned companies.

IRS Commissioner Shirley D. Peterson said earlier this year, however, that IRS statistics do not confirm the possible $30 billion in lost taxes and that the IRS does not have an estimate of its own.

The Organization for International Investment, a lobbying group representing some 50 U.S. subsidiaries of foreign corporations, argues strongly against the legislation pending in Congress on this issue, contending that it is driven by protectionist sentiments.

Other news articles where Foreign Tax Evasion and Transfer Pricing have been mentioned:

The (London) Times, October 5, 1992, Business, *Clinton Aims to Target Foreign Firms on Unpaid Tax*, by Philip Robinson, New York

The Washington Times, October 5, 1992, Commentary, page E1, *Wrong Way to Balance the Budget, Flawed Tax Algorisms*, by Donald Lambro

Financial Times, October 9, 1992, Page 10, *Democrat Line to Tax Code Criticised*, by Nancy Dunne, Washington

Sunday (London) Times, October 18, 1992, *Business, Clinton Tax Plans Threaten UK Firms*, by Irwin Stelzer

The Independent, October 20, 1992, Page 10, *Bush Goes All Out to Hit Clinton on Taxes*, by Rupert Cornwell

The (London) Times, October 20, 1992, *Business Section, Clinton Roadshow Drifts Towards Trap of Fortress America*, Colin Narbrough

The Financial Times, October 30, 1992, Page 8, *Foreign Groups Fear Tax Assault by Democrats: New Congress May Tighten Transfer Price Rules*, by George Gresham

The (London) Daily Telegraph, October 30, 1992, Page 13, *Tax Plan Threatens Relations With Britain*

The (London) Daily Telegraph, November 5, 1992, Page 24, *UK Could Be Hit in Clinton "Tax War"*

The (Cleveland) Plain Dealer, November 6, 1992, Page 1E, *Clinton Vow Has Foreign Firms Wary*, by Miriam Hill

Financial Times, November 6, 1992, Page 6, *Foreigners Keep Their Cool on US Tax Threat*, by Andrew Jack

The (London) Times, November 12, 1992, *Clinton's $45 bn. Tax Crackdown*, by Bruce Lassman

MacLean's, November 16, 1992, Page 40, *Canadians Fear a Tax Slap; Foreign Businesses May have to Pay*, John Daly, with Glen Allen in Ottawa and Julie Cazzin in Toronto

The Nikkei Weekly, November 16, 1992, Page 3, *U.S. Tax Threat Plagues Japanese Firms; Clinton's Vow to Raise $45 billion Stirs Fears of IRS Cracking Down Harder on Transfer Pricing*, by Hiroshi Nakamae

Crain's Chicago Business, November 23, 1992, Page 4, *Fed Tax Crackdown Suspect, But Foreign Firms Here Wary*, by Paul Merrion, Washington

The Independent, November 22, 1992, Page 3, *Britons Gear Up to Fight U.S. Tax Plans*, by Chris Blackhurst

Calgary Herald, November 25, 1992, Page A1, *Millions Slipping Through Tax Net*, by Eric Beauchesne, Southam News

U.S. News and World Report, November 23, 1992, Page 16, *Foreign Taxes: Clinton's Pot of Gold?*

U.S. News and World Report, November, 30, 1992, Page 59, *Clinton's Foreign Tax Crusade*, by Susan Dentzler

Technotax: How Japan's Tax System Spurs Technology
by John P. Stern [1]

Flip the pages of a recent edition of an American business journal and you are likely to find a catalog of alleged reasons for Japanese industrial prowess: Japan's educational level is higher; its cost of capital is lower; in its factories, Japan has more TAB (tape automated bonding equipment) and fewer drugs (Japan lacks a workplace drug problem). Along with these analyses of Japan's advantages typically comes a confession that major changes in American business practices are needed to emulate the Japanese model.

Yet one major method of Japanese industrial promotion requires only tax laws and accountants, two areas in which America is highly competitive. While economists in the United States debate whether the United States should have an "industrial policy," few question the need for America to have a tax policy. Japan's high-technology tax system provides incentives to innovation and investment that should be understood by any company interested in competing with, or investing in, Japan in the 1990s.

Analysts of the American semiconductor industry have recently focused on the dramatic improvements in the competitive status of U.S industry that can be achieved by such mundane, specific changes as adopting a 3-year asset life for semiconductor production equipment. In the words of the National Advisory Committee on Semiconductors:

> *Improving depreciation schedules for capital equipment has the potential for a large direct effect on the U.S. semiconductor industry. Allowing depreciation of equipment over 3 years--a period closer to the realistic life for many types of equipment than the current 5-year allowable life--would increase the annual rate of semiconductor industry capital investment by 11 percent...The result of shortened 3-year depreciation schedules is expected to be an 11 percent increase in capital investment in the U.S. semiconductor industry. This rise is equivalent to a $450 million increase in capital spending in 1991, compared with the estimate cost to the Treasury of $180 million...through appropriate tax*

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[1] Vice President, Asian Operations, American Electronics Association; Executive Director, U.S. Electronics Industry Japan Office. Yonbancho 11-4, Chiyoda-ku, Tokyo, Japan 102. Facsimile: 03-3237-1237, Telephone: 03-3237-7195.

All yen-dollar currency calculations in this article are at the rate of ¥137 = $1.00 unless otherwise stated.

policy changes, the capital formation gap with the Japanese semiconductor industry could be significantly reduced.[2]

Japan understands the importance of tax incentives for industry: for years, Japan has provided 3-year depreciation for certain semiconductor equipment.[3] When called upon to express his New Year's wishes for 1991, a leader of the Japanese electronics industry may publicly request improvements in depreciation schedules.[4] Japanese high technology trade associations lobby for special tax incentives to promote current concerns, such as computer anti-virus measures[5] or ISDN terminal equipment.[6] The Japanese government often highlights the tax measures it has championed as examples of its attention to the interests of Japanese industry.[7] Statistics on Japanese government tax revenue reduction caused by industrial promotion taxes indicate that

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[2] National Advisory Committee on Semiconductors, Capital Investment in Semiconductors (Washington: 1990) pp. 12-13.

[3] See discussion infra.

[4] E.g., remarks of Moriya Shiki, Chairman, Japan Electrical Manufacturers' Association (JEMA) (*Nihon denki kogyo kai*), President, Mitsubishi Electric Corporation, recorded in *Dempa shimbun*, January 3, 1991, p. 7.

[5] Reportedly discussed by the Japan Information Service Industry Association (JISA) (*Joho saabisu shinko kyokai*) with the Tax Policy Study Bureau of the Liberal Democratic Party and with the Ministry of International Trade and Industry (MITI), *Nihon joho sangyo shimbun*, October 29, 1990, p. 1. Other concerns of JISA less likely to capture the imagination of politicians but more likely to capture the hearts of accountants included pleas for continuation of various incentives for computer program development, system maintenance, database creation and the purchase of computers by Japanese small businesses, *Ibid*.

[6] The Communications Industry Association of Japan (CIAJ) (*Tsushin kikai kogyo kai*) reportedly lobbied the Ministry of Posts and Telecommunications (MPT) and MITI for accelerated depreciation of 30% of basis, or a tax credit of 7% of basis, for the first year after acquisition of specified ISDN-related equipment, *Dempa shimbun*, October 6, 1990, p.5.

[7] E.g., lecture to Japanese industry, "Fiscal 1991 Tax Measures From MITI" (*Heisei 3 nendo tsusho sangyo kanren zeisei sochi*), October 15, 1990, by Mr. M. Iwata, Director, Business Behavior Division, Industrial Policy Bureau, MITI.

Japanese corporate taxpayers use these tax incentives.[8] So potent are the attractions of qualification under a tax incentive scheme that even relatively unregulated sectors of Japanese industry, such as computer system integrators, rush to register to be qualified.[9] Whatever may be written about business-government cooperation in Japan, the businessman and the tax man do not always agree: Japanese industry has lobbied for years, without success, for even

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[8] A partial summary of expected reductions in Japanese corporate (juristic person) tax revenues in fiscal 1990 due to technology-spurring tax systems would include:

Tax Program	Reduction ¥ Billions	Reduction $ Millions
• Anti-Pollution Equipment	12	87.5
• Electrical Cable Burial	15	109.4
• Technopolis	11	80.2
• Wireless Telecommunications (system started April 1990)	2	14.5
• Medical Equipment Depreciation	14	102.1
• Office Equipment Purchase By Small Businesses	45	328.4
• Software Program Reserves	19	138.6
• Research Credit	98	715.3
• Energy Technology Investment	76	554.7
• Electronic Equipment Purchase By Small Business	48	350.36
• Overseas Technology Transfers	15	109.4
Total	¥355	$2591.2

Business Behavior Division, Industrial Policy Bureau, MITI, *Sangyo zeisei handobukku* (Industrial Tax Handbook), (Tokyo: Tsusho sangyo chosa kai, 1990), hereinafter, *Handbook*, pp. 298-299. Despite significant growth in Japan's wireless telecommunications market in the last 3 years, deductions for the introduction of specified wireless telecommunications equipment were only ¥2 billion in fiscal year 1990. One Japanese wireless telecommunications trade association with which I discussed this issue attributed the relatively minor usage of the program to lack of knowledge of bits existence on the part of many Japanese corporate taxpayers, conversation with officer of Research and Development Center for Radio Systems (RCR) [*Dempa shisutemu kaihatsu sentaa*), September 18, 1991.

[9] See the list of 285 systems integrators registered under the "Comprehensive System Maintenance Reserve Program" (*sogo system hoshu jyunbikin seido*) started in 1988, *Tsusansho koho* (MITI Daily Bulletin), March 6, 1991, pp. 3-5.

shorter semiconductor equipment depreciation schedules,[10] while a Japanese trade association was reportedly 'shocked" at the rejection of its proposals for reduced depreciable lives for PBX (private branch telecommunications exchange) equipment.[11]

Japan's industrial promotion tax benefits are vast in scope, often aimed at modifying even macroeconomic trends such as the

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[10] The argument that technological leapfrogging in the semiconductor industry requires shorter depreciable lives does not seem to move the tax policy experts of the Liberal Democratic Party, who typically approve the semiconductor asset depreciation schedule for extension without revision, *see, e.g., Tsusansho koho*, January 8, 1987, p.6. Kyocera Inc., a leader in ceramics and electronics technology, has reportedly used, at least for internal accounting purposes, depreciable lives that are a fraction of the depreciable lives set by Japanese tax law, because it believes that the tax law depreciable lives are too long given the rapid pace of technological obsolescence in its business. For example, while the Japanese tax law sets 11 years as the depreciable life of printers used in electronic component manufacture, automatic production equipment used in electronic device manufacture and equipment used in manufacturing optical products, Kyocera uses an internal usable life of 5 years for each asset. Matsushita Electric Industrial Co., Ltd reportedly uses a depreciation schedule "20%-30% shorter than the tax law schedule," Kiyoshi Okamoto, Masaaki Miyamoto and Mitchiharu Sakurai (eds.) *Hai tekku kaikei* (High-Tech Accounting), hereinafter, *High Tech Accounting*, (Tokyo: Doyukan, 1988), pp. 122-123.

[11] Activities of the CIAJ reported in *Dempa shimbun*, January It, 1987, p.5. Japanese industry was ultimately successful in convincing the Ministry of Finance to lower the depreciable life of a variety of equipment, including optical disks (from 10 to 6 years), push-button telephones (10 to 6 years) and digital PBX telecommunications exchanges (10 to 6 years), starting with the 1988 fiscal year. *Handbook*, p. 10. The December 3, 1990 estimate of MPT's "Optical Fiber City Promotion Group" (*hikari faibaa shitee suishin kondan kai*) that Japan would invest about $437 billion in optical fiber infrastructure by the year 2015 was accompanied by a call for tax incentives to build that infrastructure, *Nihon kogyo shimbun*, December 4, 1990, p. 5, and *Dempa shimbun*, December 4, 1990, p. 1. Possible tax incentives include a credit of 7% of the amount invested in qualified facilities or accelerated depreciation of 30% of cost in the first year of acquisition. Facilities for the manufacture of optical fiber currently have an 8-year depreciable life, Kinichi Yoneyama and Tasuke Sakamoto, eds. *Genka shokyaku no zeimu to taeyo nensu no subete* (Depreciation Tax Practice : All About Depreciable Lives) (Tokyo: Zeimu keiri kyokai, 1990), hereinafter, All About, p. 152.

effect of an appreciated yen on Japanese industrial competitiveness[12], or deeply-ingrained business behavior, such as the reluctance of Japanese industry to transfer technology overseas[13], or even global issues like the reduction of ozone-destroying chlorofluorocarbons (CFCs)[14]. The fiscal 1991 program of just one ministry, MITI, covers everything from tax incentives Co prepare Japanese shopkeepers to compete with large stores such as Toys "R" Us, to financial bait to lure companies away from excessive concentration in the Greater Tokyo area.[15] A thumbnail,

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[12] E.g., the Japanese Cabinet approved on May 29, 1987 a package of "emergency economic measures" that included an additional 201 accelerated depreciation, during the period October I, 1987-October 1, 1988, for expenses on technologies to improve competitiveness in the face of a high-yen induced recession, *Denshi* (monthly magazine of the Electronic Industries Association of Japan), 1987-11, p.35.

[13] On April 1, 1989, Japan began a loss deduction equal to 22% of the payment received on the transfer overseas of a patent by a Japanese company, or 16% of the payment received for a technical transfer, up to a limit of 40% of income in the tax year, *Tsusansho koho*, July 12, 1989, pp. 9-30. This program apparently resulted in qualified transactions worth more than $109 million in 1990, note 8, *supra*.

[14] E.g., special depreciation on corporate or personal income taxes of 21% of basis in the first year after acquiring devices for controlling or recycling CFC emissions. This is in addition to a special valuation, for fixed asset -tax purposes, of CFC emission control or recycling devices at 60% (rather than 100%) of acquisition cost for the first three years of use. Refiners and transporters of volatile oils benefit from a partial exemption from excise taxes on volatile oils if those oils are used for the manufacture of CFC-reducing solvents. *Denshi kogyo geppo* (monthly magazine of the Japan Electronic Industry Development Association), July, 1989, p. 59.

[15] See abstract of tax plans for the "Development of a New Policy for the Distribution Industry" (*Arata no ryutsu Songyo seisaku no tenkai*) and "Envigoration of the Provinces and Correction of Excessive Concentration in Tokyo" (*Tokyo ikkyoku shuchu zesei to chiiki no katsuseika*), *Tsusansho koho*, January 9, 1991, p. 10. Among the better-known multi=-ministry regional investment tax incentive programs currently in force is the "Technopolis" program. Under the Technopolis program, investments in certain industries of more than ¥1 billion in factories (including software development facilities) situated in designated areas are eligible for special depreciation, in addition to other depreciation, of 30% of facilities cost (15% of building cost) in the first 5 years after investment, 25% of facilities (or 13% of buildings) in the 5th-7th year after investment, and 20% of facilities (10% of buildings) in (continued...)

summary, discussion of all of Japan's industrial promotion taxes might take more than 300 pages[16]; a detailed discussion of just one of Japan's technology-spurring taxes[17] is over an inch thick. Since these tax benefits can be claimed by any Japanese corporate income tax payer, including a foreign-owned one, there may be financial advantages for a foreign company in doing research and development in Japan. In this article, I would like to highlight the features of a few of Japan's industrial promotion tax incentives that offer instructive contrasts to America's handling of similar issues.

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[15](...continued)
the 8th year after investment. There are more than 60 designated industries, including the manufacture of liquid crystals, software, digital audio disks, consumer electronics, wireless telecommunications, industrial robots, semiconductor materials, optical fiber and cable, avionics, and analytical, scientific and measuring equipment. *Handbook*, pp. 86-87.

[16] The *Handbook* takes 337 pages to sketch the subject. It lists 22 different high-technology related tax programs, pp.11-13.

[17] Technology Promotion Division, Agency for Industrial Science and Technology, Ministry of International Trade and Industry, *Haiteku zeisei no kaisetsu* (Explanation of the High Tech Tax System), (Tokyo: Tsusho sangyo chosa kai 1990), hereinafter, *High Tech*.

Key Technologies Credit

Japan has a number of research and development tax credits, of which the most technologically focused credit available to large companies[18] is the Key Technologies Credit[19] that started on April 1, 1985. The original list[20] of key technologies has been supplemented twice[21]. The list of research eligible during the period April 1, 1990 - March 31, 1993 included 132 technologies. The credit amount is equal to 7% of the acquisition (or qualified lease) cost of assets used in development of the specified technologies or 15% of the corporate income tax, whichever is lesser, with a one-year carry forward of any leftover.[22] The Key

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[18] Some Japanese tax credits are available only to "medium and small enterprises," defined in Article 42-2 of the Special Taxation Measures Law (*Sozei tokubetsu sochi ho*, Law No. 73 of 1950), hereinafter, *Special Tax Law*. A medium or small enterprise i, a juristic person satisfying all of the following requirements: (a) it employs 1,000 or fewer persons; and (b) it has fixed capital or invested capital of less than ¥100 million; and (c) one half or less of the issued shared or fixed capital belong to a related juristic person that does not satisfy (a) and (b) above. The aim of this definition is to prevent large corporations from claiming benefits meant for true small businesses. In the 1989 fiscal year, only 4.3% of the corporate research and development in Japan was conducted by "medium and small enterprises;" the remaining 95.7%, ¥6.9082 trillion ($50.42 billion) was performed by large corporations, *High Tech*, p. 13.

[19] Key Technologies Research and Development Credit (*kiban gijutzu kenkyu kaihatsu sokushin zeisei*), Article 42-4-2 of the *Special Tax Law*.

[20] See Stern, "Japan's R&D Tax Credit System: What the Sales Manager, Engineer, Research Director and Executive Should Know," *Journal of the American Chamber of Commerce in Japan*, April 1987.

[21] Supplementary technologies were added for the period April 1, 1988-March 31, 1990, *Denshi*, 1987-11, pp. 36-37.

[22] The credit applies to the "expenses for research and testing into the improvement, study or discovery of manufacturing technologies." It is meant primarily to cover the cost of materials, personnel and related expenses for research, but also allows as an expense such items as the portion of existing facilities depreciation, rent, maintenance and outside procurement costs related to the project. "Outside procurement costs" likely to be allowed include the costs of having designs, models or experimental equipment fabricated by a subcontractor, but the research itself may not be sent outside. If one receives funding
(continued...)

Technologies Credit may be used even if a company has no increase in research and development expenses during the tax year.[23]

The Key Technologies Credit will not benefit generally useful research; rather, the Japanese tax law itself encourages work on highly specific technologies, such as

> Facilities, including internal construction, ventilation equipment (with HEPA filters only) and automatic environmental control systems (that is, equipment that automatically controls temperature, humidity, pressure and cleanliness) to create specialized rooms with a floor space of less than 100 square meters, in which particles with a diameter of 0.5 microns or larger are suspended in the ambient air at a density of less than 100 particles per 28,316.8 cubic centimeters. (Item No.1).

MITI's explanation of the desired technology assists Japanese businessmen and researchers to understand the turgid tax law prose. For example, the description above is explained as "a higher standard clean room than the U.S. Standard 209B Class 100 clean room"[24], while the description of the DNA synthesizer apparatus desired by the Japanese tax authorities shows a picture of the product of an American company, Applied Biosystems, Inc., Chat the Key Technologies Credit aims to improve in Japan.[25]

Technologies specified by the Key Technologies Credit include some that Japan already excels in (semiconductor production technology, flat panels, KDTV, robotics, metallurgy) as well as some in which Japan has yet to establish a clear lead (biotechnology, rocket engines, space station environment control,

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[22](...continued)
from a source outside of one's company (including funding from the Japanese government) that amount must be excluded from the expenses eligible for the credit. *High Tech*, pp. 8-9.

[23] *High Tech*, pp.10-17. A second system of Japanese research and development tax credits, available since January 1, 1968 to large companies without regard to specified technologies, is not discussed at length in this article. This second type of tax credit requires that there be an increase in research and development expenses during the tax year. This system offers a deduction of up to 20% of the increase in qualified research and development expenses, up to a limit of 10% of the corporate tax. When used in conjunction with the Key Technologies Credit to generate a total deduction for research and development costs, the limit is 15% of the corporate tax. *Handbook*, pp. 114-115.

[24] *High Tech*, p. 32.

[25] *High Tech*, p. 421.

optical fiber, plastics). Since, to the author's knowledge, the current list of Key Technologies Credit fields of research has never been translated into English, that list is translated below (subjects in boldface are indicated by MITI to have applications in semiconductor production technology):

1-1. **Class 100 Glean Room**

1-2. Electromagnetic Emissions Dampening Chamber

2. Recombinant DNA Isolation Laboratory

3-1. Computerized Infrared Spectrum Analyzer

3-2. Computerized Plasma Spectrum Analyzer

3-3. **Spectrum Analyzer Using 0.005 Nanometer Laser**

4-1. Fluorescent X-Ray Spectrum Analyzer

4-2-1 X-Ray Diffractor For Peptide Analysis

4-2-2 X-Ray Diffractor With ≤10 Micron Beam Width

4-2-3 Electron Microanalysis System

5-1. Peptide Microanalysis System

5-2. Ion Microanalyzer

5-3. Quadrupole High-Vacuum Analyzer

5-4. Laser Son Analyzer

5-5 Glow Discharge Analyzer

6. He-Ne Laser Chromatography Device

7. Ion Chromatography Device

8. Superconducting 24.7 Tesla NMR Device

9. ≥21 Tesla, 28 GHz ESR / NMR Device

10-1. **High-Vacuum, Mg Light X-Ray Atomic Analyzer**

10-2 Ion Beam Diffraction Analysis Equipment

11-1. High-Vacuum Surface Roughness Measurement Device

11-2. **Electron Beam Surface Analysis Device**

12-1. X-Ray CT Scanner

12-2. Impulse Furnace Computerized Oxygen / Nitrogen Analyzer

12-3 Automatic DNA / RNA Synthesizer

12-4. Nucleic Acid Multiplier Device

13-1. Nucleic Acid Cleaver

13-2. DNA Sequencer

14. Automatic Edman-Method Peptide Cleaver

15-1. Cell Micromanipulator

15-2. Laser DNA Microinjector

16. Amino Acid Analyzer

17. ELISA Antibody Analyzer

18-1. Chemiluminescence Measuring Device

18-2. Cellular Calcium Density Measuring Device

19. Multichannel TAG Fluorescent Spectrum Analysis

20-1. X-Ray / Laser Beam Fluid Particle Counter

20-2. Surface Particle Measurement Device

20-3. Airborne Particle Counter

20-4. Condensation Nucleus Counter

21-1. LED Beam Particle Dispersion Counter

21-2. Laser Beam Particle Dispersion Counter

22-1. High-Temperature Micro-crack Stress Detection Device

22-2. High-Temperature Hardness Detection Device

22-3. High-Temperature Micro-Creep Detection Device

22-4. Temperature Stress Cycling Apparatus

23. Heat Shock Testing Device

24. Acceleration Shock Deformation Testing Device

25-1. High-Speed, High-Pressure friction Testing Device

25-2. Repetitive Motion Friction Testing Device

26-1. Laser Flash Heat Resistance Testing Device

26-2. Ultra-High Temperature Heat Deformation Testing Device

26-3. Electrically-Induced Heat Deformation Testing Device

27-1. Amorphous Material Continuous Testing Apparatus

27-2. Amorphous Material Vibration Testing Apparatus

28-1. Divergent Temperature Balance Apparatus

28-2. DS Counter

29. Viscosity Counters (3 types)

30-1 Superconductivity Critical Point Cryostat

30-2 Superconductivity Critical Point Current Meter

30-3 Superconductivity Critical Point Magnetic Detector

31-1 Laser Oscillation Testing Equipment

31-2 Variable Wide-Band Laser

31-3 Optical Spectrum Analyzer

32-1 Solar Cell Testing Device

32-2 Optical Fiber Signal Loss Testing Equipment

33-1. ≥50MHz IC Logic Tester

33-2. ≤1 Micron Beam Spot E-Beam IC Fester

33-3. Tester For SC Patterns Of ≤20 Microns

34. Flat Panel Display Tester

35-1. HDTV CRT Tester

35-2. MUSE System HDTV Signal Generator

35-3. Optical Data Storage Media Teeter

35-4. Magneto-Optical Data Storage Media Tester

36-1. Microsurface Infra-red Temperature Gauge

36-2. Infrared Stress Gauge

37. Semiconductor Material Purity Thermal Tester

38. Manual Prober With Terminala ≤2.5 Microns
39. ≤20 Angstrom Surface Coarseness Gauge
40. Research Elipsometer
41. Optical Recording Media Tester
42. Laser Beam Mask Pattern Measuring Equipment
43. Computerized 3-D Micromeasuring Equipment
44. 3-D Robot Motion Non-Contact Measuring Device
45. Outer Space Robot Weightlessness Simulator
46. Machine Tool Electromagnetic Noise Measuring Device
47. Optical Measuring Device With Error Of $\leq \frac{00294}{50}$ Meters
48. Vibration Measurement Device
49. Helium Leak Detector
50. Molecular Structure Analysis Graphic Workstation
51. Multi-user, Multi-task Software Engineering Workstation
52. ≥400 MFLOPS Scientific Supercomputer
53-1. Electron Microscope
53-2. X-Ray Microanalyzer
54. Scanning Tunnel Microscope
55. Scanning Acoustic Microscope
56. High Temperature Materials Analyzer
57. Plasma Arc Crucible
58. E-Beam Crucible
59. Glass Material Crucible
60. Malleable Conducting Polymer Process Apparatus
60-2. Thin Film Polymer Process Apparatus
61. Computerized Biological Cell Sorter
62. Centrifugal Microorganism and Cell Classification System

63. Nucleic Acid Chromatography System

64. Peptide Refining System

65. ±1°C Temperature-Controlled, 250,000 RPM Ultracentrifuge

66-1. Carbon Fiber Filament Process Apparatus

66-2. Rocket Nozzle Graphitized Carbon Processing Apparatus

66-3. Fine Ceramics Process Apparatus

66-4. Ceramic Oxide Fiber Process Apparatus

66-5. Ceramic Fiber Processing Apparatus

66-6. Specialized Glass Formation Apparatus

66-7. Ultrahigh Pressure Glass Formation Apparatus

67-1 Hot Isostatic Press

67-2. Hot Press

68-1. Semiconductor Materials Anealing Apparatus

68-2. Glass Plate Anealing Apparatus

69. Engineering Plastic Extrusion Apparatus

70 Computerized Epoxy/Phenol/Polyamide Plastic Tester

71-1 Specialized Glass Furnace

71-2. High Purity Quartz Glass Testing Apparatus

72. ≤10Hz ~ ∫110ΓΗζ Σπεχτρυμ Αναλψσισ Εθυιπμεντ

73. ∫100Ηζ ~ ∫60ΓΗζ Μιχροωαϖε Νετωορκ Αναλψζερ

74. ∫3 γιγαβιτ/σεχονδ Φιβερ Οπτιχ Διγιταλ Σιγναλ Αναλψζερ

75. ∫2000κγ/χμ² Water Press

76-1. Optical Fiber Spinning Apparatus

76-2. Halogen Glass Fiber Optical Fiber Spinning Apparatus

76-3. Conducting Fiber Spinning Apparatus

76-4. Pitch-Based Carbon Fiber Spinning Apparatus

77. Ceramic Whisker Growing Equipment

78. ≤100Å Ultra-Thin Film Deposition Apparatus

79-1 ≤10μm Film Laboratory Production Apparatus

79-2. Polymer Sheet Extrusion Apparatus

79-3. Heat-Resistant Film Production Apparatus

80. Cell Pattern Cutting Device For Research Use

81. Optical Recording Media Groove Production Device

82. Compound Material Welding Device

83. Laser Beam Cutting Device

84. Turbine Molding Device Using Ultraplastic Deformation

85. 16-dot, ≥256 Color Computer Printer Image Processor

86. Ultraprecise Mirror Grinder For VCRs, Aircraft, Copiers

87-1. Multi-Axis Ultraprecise Machine Tool

87-2. Ultraprecise Machine Tool Using Computer Feedback

88. Ultraprecise Photoelectric Forming Apparatus

89. Ultraplastic Processor Using Particulate Materials

90. Vacuum Welding Apparatus

91-1. Computer-Controlled Molten Metal Formation Apparatus

91-2 Squeeze Casting Research Equipment

92. Heat-Resistant Compound Material Fabricating Device

93. Molecular Beam Epitaxy Apparatus

94-1. Laser CVD System

94-2. MOCVD Crystal Growth Chamber

94-3. Thermal Plasma Reaction Apparatus

94-4. CVD System

94-5. Low-Temperature Plasma Apparatus For Fiber Applications

95-1 Ion Diffusion Apparatus

95-2. Multiple Wafer Ion Beam Thin Film Apparatus

95-3. Vacuum Deposition Chamber For Optical Uses

95-4. **Multi-Layer Film Spattering Laboratory Device**

96-1. **Single-Crystal Pulling Apparatus**

96-2. **GaAs Crystal Growth Apparatus**

97. Amorphous Metal Foil and Fiber Production Apparatus

98. Titanium Crystal Solidification Research Apparatus

99-1. U.V.-Sensitive Plastics Coating Device

99-2. Carbon Fiber Coating Device

99-3. Roll Coating Device

99-4. Carbon Fiber Anti-Oxidation Coating Device

100. Plasma Beam Apparatus For Liquefying Tantalum

101. Semiconductor Pattern Etching Device

102. Ion Implantation Chambers

104. Excimer Laser Metallic Film Growth Device

105. **Laser Trimming Device**

106-1. Ion Beam Of $\leq 8\mu m$ Width Pattern Exposure Device

106-2. Shadowmask Of $\pm 1\mu m$ Error Creation Device

107-1. Computerized Carbon Fiber Weaving Device

107-2. Composite Wire Production Equipment

107-3. Multilayer "Prepreg" Sheet Production Apparatus

107-4. Ultraprecise Fiber Protusion Device

107-5. Spacecraft Reentry Heat Shield Production Device

108-1. Carbon Fiber Surface Finisher ("Wet")

108-2. Carbon Fiber Surface Finisher ("Dry")

108-3. Carbon Fiber Surface Finisher ("Plasma")

109. Metal and Glass Impregnation Apparatus

110. High Pressure Microbiological Sterilization Apparatus

111. Automatic Bacterial Colony Manipulation Device

112. Precision Mass Cell Culture Equipment

113-1. N_2-O_2-CO_2 Incubator For Recombinant DNA

113-2. Hollow Fiber Cell Culture Equipment

113-3. Microbiological Colony Environmental Ordering Apparatus

114. DNA Synthesizer

115. Peptide Synthesizer

116. Cell Fusion Apparatus

117. Bioreactor

118. HEPA Filter Class 100 Clean Bench

119. Recombinant DNA Laboratory Safety Cabinet

120-1. $\geq 0.08\mu m$ $\leq 0.12\mu m$ Polystyrene Latex Particle Generator

120-2 POP Particle Generator

121-1 Outer Space Environment Simulator

121-2. Simulator: Atomic Oxygen In Outer Space Production

122. Inertial Moment Measuring Device

123. 3-Axis Computer-Controlled Satellite Movement Simulator

124-1 Simulator For Degassification Of Materials In Space

124-2 Outer Space Simulator For Materials Stress Testing

125. Rocket Engine Vacuum Test Apparatus

126. Rocket Engine Spin Test Apparatus

127. Rare Earth Recovery Equipment

128. Iron Ore Reprocessing Apparatus (2 Types)

129. Pig Iron Continuous Refining Process Apparatus (2 Types)

130. Realtime Computerized Continuous Forming Apparatus

131. Production Apparatus For C_1 Chemistry

132. Supercritical Fluid Separation Apparatus

How effective has the Key Technologies Credit been? Some of the technologies included on the list of eligible technologies (such as Class 100 clean rooms or 400MFLOP supercomputers), while state-of-the-art in 1985, are no longer on the forefront of innovation, although a Class 0 clean room or a 1000MFLOP supercomputer would still qualify for the credit.[26] It is clear, though, that Japanese industry's use of research and development tax credits exceeded $715 million in deductions in 1990, and has been at a similar level for at least the last 5 years.[27] The cumulative total amounts to several billion dollars more in tax incentives for the development of key technologies than one suspects has been available to industry in the United States.

Depreciation

Depreciation is a common deduction representing the declining value of an asset as it goes from the receiving dock to the scrap heap, but in Japan it is increasingly used to stimulate new technologies and the expansion of markets. Accelerated depreciation encourages manufacturers to replace equipment rapidly in industries, such as semiconductors, in which technology may become obsolete every few years. By making it easier for manufacturers to buy new semiconductor production equipment, Japan also assists the semiconductor equipment companies that wish to sell such equipment. When accelerated depreciation is offered only for specified mobile telecommunications equipment installed during a short period, the effect can be one of offering buyers an incentive to purchase new telecommunications technology immediately, rather than waiting several years. Thus, depreciation in Japan is also used to speed up the growth of an installed base of certain technology.

The general Japanese depreciation tables for high-technology assets are unremarkable.[28] They become more potent, however, when

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[26] The typical wording for a technology eligible for the Key Technologies Credit specifies a lower limit of technology, e.g., "Class 100 and below" or "400MFLOPS and above".

[27] The loss of tax revenues by the Japanese government due to the research and development tax credits (including the Key Technologies Credit) was ¥93 billion in 1985, ¥96 billion in 1986, ¥90 billion in 1987, ¥93 billion in 1988, ¥95 billion in 1989 and ¥98 billion ($715.325 million) in 1990. Prior to the introduction of the Key Technologies Credit for the 1985 tax year, yearly deductions were ¥27 billion in 1981, ¥32 billion in 1982, ¥38 billion in 1983 and ¥51 billion in 1984. *Handbook*, pp. 302-303.

[28] The depreciable life of an asset for tax purposes is fixed, in general, by the Ministerial Order Concerning the Depreciable Life of Assets (*Genka shokyaku shisan to taiyonensu-to ni kansuru*
(continued...)

one realizes that added depreciation is allowed when certain assets are used operated more than eight hours a day[29], or when they are used in qualified research and development[30].

At least since 1979, Japan has offered accelerated depreciation for facilities for producing integrated circuits of more than 100 elements.[31] It is not unheard of for depreciation to surpass wages and personnel costs in the financial structure of

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[28](...continued)
shorei), Ministry of Finance, March 31, 1990, as amended, hereinafter, *Depreciation M.O.* The scrap value of most high technology equipment is assumed to be 10 percent of acquisition cost, *Depreciation M.O.* Schedule 11. The depreciable life of semiconductor element production facilities is generally seven years (asset class 271), but can be much lower for the designated semiconductor production equipment discussed *infra*. Printed circuit board production facilities generally have a six-year life (asset class 272-2), as do digital telecommunications and international telecommunications equipment (asset class 343). Consumer or industrial electronics production equipment has an 11-year life (asset class 267) and electrical measuring devices, telecommunications equipment and components for electronic equipment not otherwise specified have a 10-year life (asset class 268).

[29] Substantially all electronics-related equipment, except radio and television broadcasting equipment, is assumed to be used eight hours a day in normal use, Reizo Nakase, ed., Genka shokyaku shisan taeyo nensu hyo (Tables of Depreciable Assets), (Tokyo: Nozei kyokai rengokai, 1990) pp. 115-120. If a machine with an eight-hour official usage is run for twenty-four hours a day 365 days a year, the excess depreciation allowed in addition to other schedules is

roughly 16 [i.e., 24-8] x $\frac{35}{1000}$ *Ibid*, pp. 368-369. See also,

All About, pp. 320-325. Certain facilities are excluded from 24-hour depreciation, such as utilities, research facilities, antipollution devices and storage machinery, *All About*, p. 325.

[30] Buildings and rooms (such as clean rooms) used in research have a five-year asset life; tools, measuring equipment, projectors and calculating equipment can be depreciated over four years; and pumps, motors, metal fabrication devices, antennas and tanks over seven years, *Depreciation M.O. Schedule 9, Handbook*, p. 74.

[31] Ministerial Directive No. 2-22-2-1 (*Taeyo nensu tsutatsu*) 2-22-2-1, Schedule 5, "Depreciation Schedule For Equipment and Devices For New Industries" (*Shinki sangyo kikai oyobi sochi no taeyo nensu hyo*), *All About*, pp. 228-229.

a Japanese semiconductor factory.[32] The designated equipment, with the applicable depreciable life (in years), is contained in the table below:

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[32] E.g., the statement of a manager in Oki Electric Co., that "If we look at the structure of expenses, we find that depreciation of facilities investment increases constantly. For example, if we take 1978 as a base, by 1980 the figure is twice as large, by 1982 it is four times as large, and by 1983 it is six times as large, 90 that there is a doubling every two years. In the past, personnel expenses were the chief expense, but recently depreciation is close to exceeding personnel costs, and if we look at bust the [costs] directly attributable to manufacturing, depreciation already exceeds personnel costs." Quoted in *High Tech Accounting*, p. 266.

Mask Design Equipment	4
Precision Reducing Equipment	4
Stepper Equipment	4
Developing Equipment	4
Clean Benches	5
Comparators	4
Grinding Equipment	4
Diffusion Furnaces	3
Epitaxial Growth Equipment	4
Oxidizing Furnaces	4
Mask Aligners	4
Developers	5
Sputtering Equipment	4
Aluminum Furnaces	4
IC Testers	4
Scribers	5
Glow Bars	4
CVD Devices	4
Mounters	4
Wire Bonders	3
Mold Presses	4
Temperature Controllers	4
Burn-In Furnace	4
High-Temperature Baths	5
Low-Temperature Baths	5
Other Testing Equipment	8
Other Inspection Equipment	4
Water Cleaning Equipment	10
High-Pressure Devices	10
Effluent Control Devices	7
High-Purity Gas Fixtures	10
Cranes	15
Compressors	10
Water Pumps	10
Boilers	15
Transformers	15
Electrical Wiring	15

Accelerated depreciation according to the Japanese tax tables can generate deductions more swiftly than is typical in the United States for similar equipment, as graphically illustrated below[33]:

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[33] Nakaso, supra, back cover. Depreciable balances on an asset worth 100 are: Japan, 8 hours a day, Year 1, 46.40, Year 2, 21.50, Year 3, assumed scrap value of 10.00; Japan, 24 hours a day, 365 (continued...)

Thus, much semiconductor production equipment can be depreciated in Japan at rates that approach the ideals sought by the National Advisory Committee on Semiconductors Report.

Since 1990, the Ministry of Posts and Telecommunications ("MPT") has used depreciation under the "Tax Program for the Efficient Use of Electromagnetic Spectrum"[34] to promote the efficient use of limited resources such as the electromagnetic spectrum by making tax benefits for the use of wireless telecommunications equipment more widely available. Long-term goals of MPT include the greater use of wireless telecommunications equipment in Japanese society and the promotion of the telecommunications industry.[35]

The Tax Program for the Efficient Use of Electromagnetic Spectrum offers special depreciation of qualified equipment at the rate of 30% of basis for equipment purchased in 1990, 20% of basis for equipment purchased in 1991, and 10% of basis for equipment purchased in 1992.[36] Equipment eligible for the deduction is described in detail[37] and centers on automatically-switched mobile two-way MultiChannel Access telecommunications and Automatic

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[33](...continued)
days a year, Year 1, scrap value of 10.00 (deduction of 102.40 subject to scrap value limit); U.S., 5-year straight line depreciation, scrap value of 10.00 assumed, Year 1, 80.00, Year 2, 60.00, Year 3, 40.00, Year 4, 20.00. Year 5, 10.00.

[34] *Shuhasu yuko riyo sokushin zeisei*; qualified equipment defined in *Special Tax Law*, Article 20-11, *Kampo* (Official Gazette), March 31, 1990, *gaigo*, pp. 16-17.

[35] *RCA News* No. 235 (Bulletin of the Research and Development Center for Radio Systems), January 23, 1990, pp. 1-3.

[36] *RCA News*, *supra*, p. 1. The tax plan also envisions a deduction of 7% of an amount equal to 60% of the lease payments if the qualified equipment is leased, *Nikkan kogyo shimbun*, December 19, 1989, p. 1, reporting on outcome of deliberations of the Liberal Democratic Party Tax Policy Study Bureau.

[37] E.g., "'common-use mobile radio telecommunications transmission facilities;' i.e., apparatus used by two or more persons jointly using radio waves to send a mobile radio signal, which using a dedicated computer that operates to control or process data only, automatically selects an open channel from 5 or more radio channels and has the ability to transmit a signal; the term also includes attendant computers, dedicated printers, data storage facilities and power supplies.", *Kampo*, March 31, 1990, *gaigo*, p. 17. The equipment must cost more than ¥1.6 million, *All About*, p. 10

Vehicle Monitoring technology similar to that offered in Japan by Nippon Motorola, Ltd and other telecommunications firms.

Conclusion

Tax breaks did not make the Walkman®. Japan's tax system does not create, manufacture or market new products, but it does whittle down even further the monetary risk that Japanese corporate taxpayers must take in developing new products because, in effect, the Japanese government cuts their taxes if they compete in a specified fashion. Japan's web of tax incentives for industry, while not seen as perfect even by Japanese businessmen[38], offers an explanation of Japanese technological cooperation far more understandable to Washington than alien notions of keiretsu or "government large-scale projects." Already some of the more politically active segments of American industry, such as semiconductor makers, have sought Congressional sponsorship of legislation[39] to remove portions of U.S. tax law that impede their ability to compete with a Japanese semiconductor industry favored with special credits and depreciation. The rest of high technology manufacturing in America could also benefit by removing its blinders, studying Japan's technology-spurring tax system, and putting on its green eyeshades to work for a more competitive industrial tax system in the United States.

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[38] Companies such as Mitsubishi Heavy Industries, Sumitomo Electric, Hitachi Ltd, Nissan Motors, Tokyo Electric Power Company and the Toray Research Center reportedly formed the Research Industry Association (*Kenkyu sangyo kyokai*) on February 27, 1991. The Association seeks to address problems in Japan's research and development tax system that, in the words of one organizer, "are difficult for each company to solve by itself, but if left alone would lead to an increase in international criticism of Japanese research and development and, it is feared, might even lead to a cessation of Japanese industry," *Nikkei sangyo shimbun*, March 4, 1991, p. 2.

[39] The Semiconductor Investment Act, H.R. 3273 (introduced August 2, 1991 by Representative Pickle (D., Texas)) and S. 1786 (introduced October 1, 1991 by Senator Baucus (D., Montana)).

NOT FOR RELEASE BEFORE 4/8/92

Vanderbilt Journal of Transnational Law

VOLUME 25 | 1992 | NUMBER 1

RICO Meets *Keiretsu:* A Response to Predatory Transfer Pricing

*James D. Harmon, Jr.**

ABSTRACT

Japanese cartels known as keiretsu *pursue illegal transfer pricing policies which cost American taxpayers billions of dollars and place American businesses at a competitive disadvantage. Keiretsu-controlled subsidiaries located in the United States buy goods, financial products or services from their Japanese parent at fraudulently inflated prices. Their dual purpose is to create artificial business expenses and costs (thereby reducing taxable income and paying little or no United States corporate income tax) and to gain an edge on American businesses through tax evasion.*

Mr. Harmon proposes that American businesses respond to this problem with techniques normally used against organized crime. The Racketeer Influenced and Corrupt Organizations Act (RICO) can combat the anti-competitive market effects of keiretsu. *When transfer pricing damages American businesses through tax evasion and money laundering,*

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The author wishes to acknowledge the assistance of Allen Hobbs of Bower & Gardner, B.A., Hamilton College, 1980; J.D., Vanderbilt University School of Law, 1987, and Christopher R. Robbins, B.S., United States Military Academy, 1962; M.B.A., Harvard Business School, 1977, in the preparation of this article.

RICO's treble damage provisions provide them with the means to recover lost profits.

RICO provides a juridical approach to what has been treated as a matter of international diplomacy. By offering a domestic legal solution to curb corporate Japan's predatory trade practices, Mr. Harmon undertakes to neutralize Japan's powerful political resources and provide a private remedy for harmful trade practices which the Government has been unable to control.

TABLE OF CONTENTS

I. INTRODUCTION

Keiretsu, Japan's closed loop production and financial enterprises, give Japanese business the advantage of an uneven playing field when they do business in the United States. For the past several years, a debate has raged in the business community on what to do about it. For example, Charles Ferguson of the Massachusetts Institute of Technology's Center for Technology, Policy and Industrial Development argues that *keiretsu*, engaging in "techno-industrial Prussianism,"[1] have all but caused United States manufacturers to lose the ten billion dollar world semiconductor market.[2] As a response, economist and author George Gilder favors the trickle-up effect of American individualism combined with new technology as a defense.[3] Ferguson, however, rejects Gilder's

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1. Charles H. Ferguson, *America's High Tech Decline*, 74 FOREIGN POL'Y 123, 140 (1989).

2. Charles H. Ferguson, *Computers and the Coming of the U.S. Keiretsu*, HARV. BUS. REV., July-Aug. 1990, at 55, 56.

3. George Gilder, *The Revitalization of Everything: The Law of the Microcosm*, HARV. BUS. REV., Mar.-Apr. 1988, at 49; *see also* GEORGE GILDER, MICROCOSM: THE

faith in small entrepreneurial companies as an inadequate response to the Japanese challenge to the computer industry. Labelling Gilder's "law of the microcosm" as voodoo competitive doctrine, Ferguson proposes United States *keiretsu*, rather than individualism, as the answer.[4]

Silicon Valley innovators cannot agree either. T.J. Rodgers, CEO of Cypress Semiconductor, endorses Gilder's ode to rugged entrepreneurialism. On the other hand, Robert Noyce, CEO of Sematech, the industry and government-funded semiconductor research consortium, calls Rodgers' approach false hope and high-tech fiction. Noyce hopes for a "well aimed light" to help American business find the way.[5]

As the debate continues, beseiged American business seems content only to hope that American government subsidy or a change in government trade policy present a solution. IBM and Apple Computer seem a notable exception. Their recently-announced research collaboration to develop *the* personal computer for the 1990s may be a big step in Ferguson's direction, although IBM's recent reorganization plan, which counts on innovation fostered through decentralization, seems to adopt the Gilder/Rodgers' approach.[6]

Congressional lawmakers of all stripes have jumped on the bandwagon seizing the opportunity to bash foreign corporations as the cause of everything from the budget deficit to higher taxes, but with little to show for their tub-thumping.[7]

Meanwhile, virtually the entire American business lobby in Washington rails at the federal anti-racketeering statute known as the Racketeer Influenced and Corrupt Organizations Act (RICO)[8] pressuring Congress

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QUANTUM REVOLUTION IN ECONOMICS AND TECHNOLOGY (1989).

4. Charles H. Ferguson, *From the People Who Brought You Voodoo Economics*, HARV. BUS. REV., May-Jun. 1988, at 55, 62.

5. T. J. Rodgers & Robert Noyce, *Debating George Gilder's* Microcosm: *T.J. Rodgers vs. Robert Noyce*, HARV. BUS. REV., Jan.-Feb. 1990, at 24, 36. T. J. Rodgers practices what he preaches. Cypress Semiconductor is operated through a system of "perpetual entrepreneurship" in which semi-independent companies are spun off to design and manufacture new products. Richard Brandt, *The Bad Boy of Silicon Valley*, BUS. WK., Dec. 9, 1991, at 64-70.

6. *It's Official: IBM and Apple Tie The Knot*, BUS. WK., Oct. 14, 1991, at 54; John W. Verity et al., *The New IBM*, BUS. WK., Dec. 16, 1991, at 112.

7. Limited congressional activity has focused on barring foreign investment and increasing reporting requirements. In 1988, as amended in 1990, Congress gave the President limited power to block foreign investment which threatened national security interests. The Omnibus Trade and Competition Act of 1988. Other bills introduced, but not enacted, would have required foreign investors to make public filings with respect to their United States based operations. H.R. 5, 101th Cong., 1st. Sess. (1989).

8. 18 U.S.C.A. §§ 1961-68 (West 1984 & Supp. 1991).

to water it down to the point where it is so diluted that it loses its potency.[9] With typical shortsightedness, American business misses the point that RICO could reverse the tide of *keiretsu* transfer pricing practices that cost the Internal Revenue Service (IRS) billions of dollars and give Japanese companies a competitive advantage in certain American markets. They should rethink their position on RICO. RICO is the hammer that American business has been looking for, but now seems prepared to throw away without even using.

II. New Rules of Engagement

This Article introduces into the debate a step-by-step plan of legal action for American business to combat some of the market effects of *keiretsu*, a key element of Japan Inc.'s industrial order of battle. It is premised on viewing the problem from an American perspective and using a uniquely American approach now within the control of U.S. companies—hardnosed litigation on the scale of Godzilla meets King Kong.

The plan would be to seize the initiative and play by American rules in United States markets, thus neutralizing the advantages of *keiretsu* activity through means normally used to prosecute organized crime.

One word of caution—the approach advanced is only a solid counterattack intended to stabilize segments of certain industries. It would only buy time for the resolution of the principles of Gilder and Ferguson, both of whom seem to know what they are talking about. I cannot speak with their authority on economic theory. But I do accept their mutual premise that the martial nature of Japanese business methods poses a real challenge, if not a threat, to American business if left unanswered.

III. Modus Operandi

Japanese *keiretsu* engage in cartel-like conduct characterized by supplier-buyer relationships impenetrable to American companies, by groups of companies related financially, through mutual shareholding[10] and interlocking directorates, and by technological interdependence. Ri-

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9. *See* H.R. 101-975, 101st Cong., 2d Sess. (1990); H.R. 1717, 102d Cong., 2d Sess. (1991); S. 438, 101st Cong., 2d Sess. (1991).

10. *See, e.g.*, Kozo Yamamura, *Will Japan's Economic Structure Change? Confessions of a Former Optimist*, *in* Japan's Economic Structure: Should It Change? 13, 28-36 (Kozo Yamamura ed. 1990) [hereinafter Japan's Economic Structure]; *see also* John O. Haley, *Weak Law, Strong Competition, and Trade Barriers: Competitiveness as a Disincentive to Foreign Entry Into Japanese Markets*, *in* Japan's Economic Structure, *id.*, at 203, 213-24.

valry is suppressed with the goal of displacing foreign competitors.[11] *Keiretsu* enterprises give Japanese firms some significant advantages, including easy access to low cost capital, a long term focus secured through stable shareholding, and a captive market for their goods and services.[12] Organized crime infiltration of the financial arms of some *keiretsu*—an idea once thought of as xenophobic drivel—no longer can be dismissed.[13]

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11. *See, e.g.*, Giovanni Dosi et al., *Trade, Technologies and Development: A Framework for Discussing Japan*, *in* POLITICS AND PRODUCTIVITY: THE REAL STORY OF WHY JAPAN WORKS 3, 32-34 (Chalmers Johnson et al. eds. 1989) [hereinafter POLITICS AND PRODUCTIVITY]; Michael Gerlach, Keiretsu *Organization in the Japanese Economy: Analysis and Trade Implications*, *in* POLITICS AND PRODUCTIVITY, *id.*, at 141.

12. Marie Anchordoguy, *A Challenge to Free Trade? Japanese Industrial Targeting in the Computer and Semiconductor Industries*, *in* JAPAN'S ECONOMIC STRUCTURE, *supra* note 10, at 301, 325-27.

13. Recently, the presidents of two major Japanese securities firms, Nomura Securities Co. and Nikko Securities Co., resigned after reports in the Japanese press that Susumu Ishii, a retired leader of the Yakuza mob, made millions through these firms. Karen L. Miller, *Suddenly the Japanese Mob Is Out of the Shadows*, BUS. WK., July 8, 1991, at 29. According to press accounts, affiliates of these firms and a bank loaned Ishii about $300 million, which he used to purchase stock in a railway company whose stock then appreciated as a result of questionable trading. This reaped huge profits to Ishii, which were then illegally invested overseas. Ishii, who also reportedly purchased an interest in a Houston software company and a New York financial services company, made about $287 million when Nikko and Nomura affiliates and others purchased worthless golf club membership certificates from a club that Ishii owned. *Id.* In testimony before Parliament, Nomura's former chairman testified that he could not remember who introduced Ishii to Nomura—an introduction that he had recalled until the day of his testimony. James Sterngold, *Testimony On Brokers in Tokyo*, N.Y. TIMES, Aug. 30, 1991 at D6.

More recently, press reports have detailed how between one and three billion dollars in loans from some of Japan's most prominent banks were funnelled through a trucking company to Yakuza controlled businesses and to Japanese politicians. The loans to the trucking company are said to be uncollectable. *Another Scandal in Japan, This Time Involving Billions*, N.Y. TIMES, Feb. 23, 1992, at D3.

The Yakuza does not operate in the shadows as does the Mafia. Instead, it chooses to be a highly visible part of Japanese society earning annual revenues estimated at about $10 billion and holding $3.6 billion of stock in legitimate companies. Miller, *supra*, at 29. Its techniques of corporate extortion include *sokaiya*, a form of blackmail whereby Yakuza members intimidate board members at annual public shareholders meetings by threatening to disclose damaging information about a company or its management. The Yakuza is adaptable enough to make its *sokaiya* services available to management as a means to silence dissenting shareholders. ALBERT J. ALLETZHAUSER, THE HOUSE OF NOMURA: THE INSIDE STORY OF THE LEGENDARY JAPANESE DYNASTY 281-82 (1990). Forty percent of 2,000 companies responding to a police survey said they had received extortionist threats, and one-third of those paid off in amounts from $750 to $775,000. The problem has gotten so bad that thousands of shareholders' meetings are held on the

Keiretsu are the means by which Japan Inc. is pursuing a national business strategy for dominance in the global marketplace. Historically, *keiretsu* penetration of the United States market has followed a now familiar two step process. First, huge quantities of equivalent or superior products (such as color televisions, VCRs, and stereo components) are shipped to the target United States market at very low prices, that is, prices below the level at which American competitors could profitably sustain production over some reasonable term. Short-term profitability does not matter because the process is sustained by: a pre-existing cartel serving the Japanese market in which high prices can be charged; reciprocal institutional equity ownership that precludes stock sale (and devaluation) on low profit outcomes; a lower cost of capital; and the strategy itself, which operates over a long time-horizon.

Ultimately the United States target market's producers and competitors are driven out with a few stragglers resorting to off-shore production. The target national market gradually accepts the low-value-added role of a warehouser or, at best, an assembler. Once this occurs, the second phase begins. Distribution channels can be intimidated and dominated. And more significantly, transfer prices to the warehouser or assembler can be raised to almost any level. Political resistance can be neutralized, or at least contained, by nationally coordinated lobbying, public relations, and promotional efforts.

Domestic corporations are victimized when tax schemes are exported into the United States, along with the goods the *keiretsu* produce and the finances and services they offer. Some *keiretsu* apparently charge artificially high prices known as transfer prices when selling goods or providing services to their United States based subsidiaries and distributors. This causes their United States operations to operate perennially at a loss or with uneconomically low profit margins, notwithstanding steadily increasing sales.[14] In effect, profits are laundered out of the United States, resulting in a substantial underpayment of federal and state income taxes. A purely domestic corporation inflating expenses to reduce taxable income undoubtedly would face a criminal tax evasion prosecution. American competitors have yet to find a legal remedy to counter the

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same day to minimize the Yakuza's efforts to disrupt. *Police Unprecedently Demand Business Groups to Cut Yakuza Ties*, Asahi News Service, June 28, 1991, available in LEXIS, Nexis Library, ASAHI File; Greedy Gansters are Putting the Squeeze on Corporate Japan, Reuters, Dec. 31, 1990, *available in* LEXIS, Nexis Library, Reuters File.

14. *Tax Underpayments By U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcomm. on Oversight of the House Ways and Means Comm.*, 101st Cong., 2d Sess. 149 (1990) [hereinafter *Tax Underpayments*] (statement of IRS Case Manager Neil McNulty).

competitive advantage gained through this foreign initiated form of tax evasion.

The potential for transfer price manipulation should increase with Japan Inc.'s escalating direct investment in the United States. From 1986 through 1989, corporate Japan's direct investment through affiliate companies increased by ninety-eight percent. During the same period, corporate Japan increased its United States direct investment tenfold through corporate acquisitions.[15]

The success of *keiretsu*'s predatory and monopolistic transfer pricing practices has forced many segments of American business into a veritable defensive perimeter. The RICO hammer offers a strategic counterstroke, attacking the tax fraud Achilles heel of Japan Inc., to re-establish genuine competitiveness. A more precise definition of *keiretsu* is no more necessary to address transfer pricing schemes than it was necessary to define organized crime in order to reach gangster Al Capone for tax evasion.[16]

This process of profit laundering is not unique to Japan Inc. Italian financier Michele Sindona, a man with political, Vatican, and mob ties who caused the collapse of the Franklin National Bank,[17] first described cross-border tax evasion through inflated prices to me when I was analyzing the phenomenon of money laundering for the President's Commission on Organized Crime.[18] He offered this service to his clients which made his law firm the most successful in Milan, Italy.[19] Sindona saw the process for what it was—tax evasion—so that when Italy made tax evasion a crime, he claimed to have stopped doing it.[20]

Federal anti-money laundering laws, which the President's Commission proposed and which Congress adopted in 1986, owe much to Sindona's insights. Sindona's grandiose sounding, but correct, view that the real evil of money laundering is its power "to consume entire sectors

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15. Alan J. Auerbach and Kevin Hassett, *Taxation and Foreign Direct Investment in the United States: A Reconsideration of the Evidence* at 16, 17 presented as a working paper at the Conference on the International Aspects of Taxation, Cambridge: National Bureau of Economic Research, Inc. (Sept. 27, 1991). However, a recent press report indicates that the Japanese are reducing their investment abroad, James Sterngold, Japanese Shifting Investment Flow Back Home, N.Y. Times, Mar. 22, 1992, at A1.

16. Capone v. United States, 56 F.2d 927 (7th Cir.), *cert. denied*, 286 U.S. 553 (1932).

17. Sindona v. Grant, 619 F.2d 167 (2d Cir. 1980); President's Commission on Organized Crime, Interim Report to the President and Attorney General, The Cash Connection: Organized Crime, Financial Institutions and Money Laundering 83 n.3 (1984).

18. Nick Tosches, Power on Earth 87-98 (1986).

19. *Id.*

20. *Id.*

of . . . economies, transforming them into *feudi* of an international . . . oligarchy beyond the reach of the law,"[21] is an apt description of the Bank of Credit and Commerce International (BCCI) which succumbed to these anti-money laundering laws[22] Federal anti-money laundering laws, when used in combination with the RICO statute, also could reach transfer pricing schemes involving income tax evasion.

IV. Tax Fraud in the Billions

The United States Treasury loses billions of dollars in tax revenues annually through transfer pricing techniques which launder profits overseas to tax havens. The precise amount of lost tax revenues is difficult to quantify, but the indications and estimates are staggering. IRS Commissioner Fred T. Goldberg has concluded that, as a result of transfer pricing abuses, the United States government is being shortchanged billions of dollars annually.[23] Foreign controlled corporations doing business in the United States paid only 4.4 billion dollars in federal income taxes in 1987 [See Chart #1], but reported taxable income as a percentage of their gross receipts that was less than half the taxable income reported by American companies doing business in the United States.[24] [See Chart #2]. One Congressional investigator has estimated that foreign companies operating in the United States underpaid 16.5 billion dollars in federal income taxes in 1987 alone.[25]

A House Ways and Means Committee study of ten years of income tax returns of thirty-six foreign owned automobile, motorcycle, and electronics equipment distributors indicated that one-half of them paid little or no United States taxes. [See Box #1] One foreign-owned company sold more than 3.5 billion dollars in goods in the United States, had gross profits of almost 600 million dollars and paid only 500 dollars in federal income taxes during that ten-year period.[26]

If these figures even approach the norm, transfer pricing schemes could account for a significant part of the international trade deficit with

21. *Id.* at 89.

22. Jonathan Beaty & S.C. Gwynne, *The Dirtiest Bank of All*, Time, July 29, 1991, at 42-47.

23. *Tax Underpayments*, *supra* note 14, at 62 (testimony of Fred T. Goldberg, IRS Commissioner).

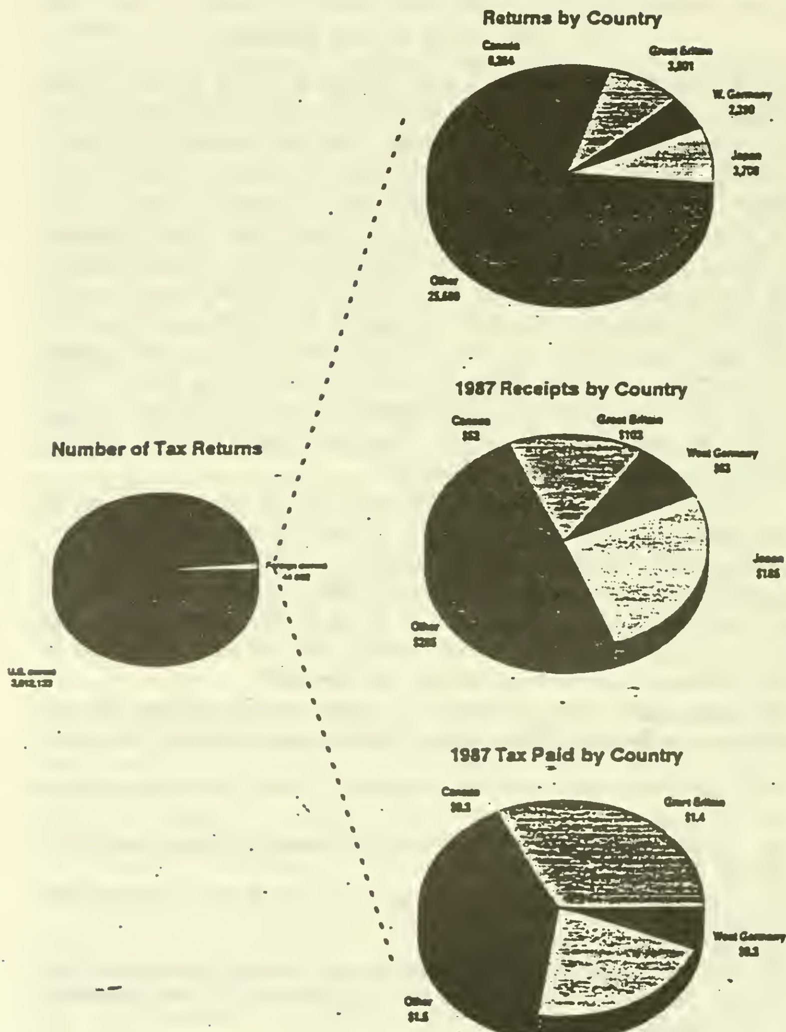
24. *Id.* at 65.

25. William Triplett, Staff Member, Senate Foreign Relations Committee, Remarks of the U.S. Business & Industrial Council News Conference, Oct. 9, 1990, *available in* LEXIS, Nexis Library, Current File.

26. *Tax Underpayments*, *supra* note 14, at 15 (opening Statement of Chairman J.J. Pickle).

CHART 1

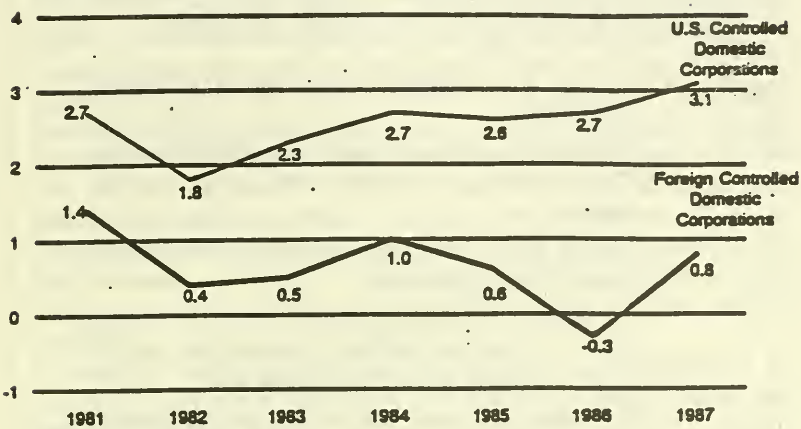
Foreign-Controlled U.S. Corporations
(in billions of dollars)



Source: Internal Revenue Service

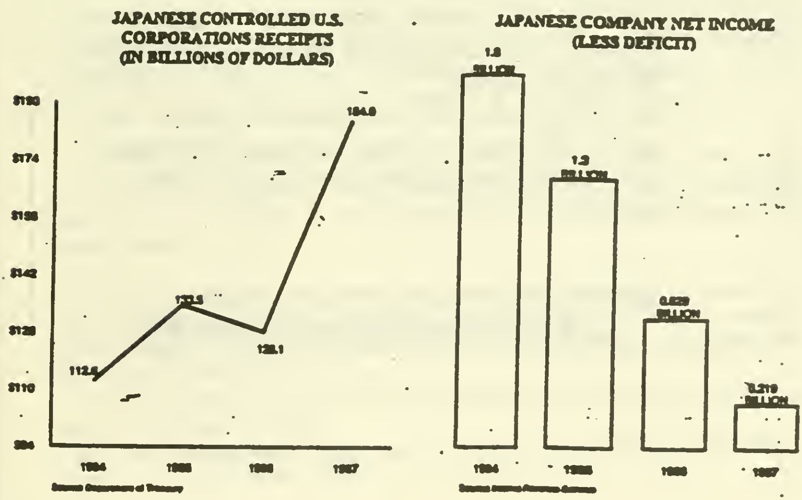
CHART 2

Net Income (Less Deficit) as a Percentage of Total Receipts (In Percent)



Source: Internal Revenue Service

CHART 3



BOX NO. 1

A TEN YEAR SNAPSHOT

The House Ways and Means Committee analyzed the federal income tax returns filed over a ten year period by 36 foreign owned U.S. distributors of automobiles, motorcycles and electronics equipment including televisions, stereos, FAX machines and VCR's. The study produced the following conclusions:

- One-half of the companies paid little or no federal income tax;
- The major tax issue for these companies before the IRS is reduction in taxable income through transfer pricing;
- Most of the 36 companies engaged in questionable transfer pricing practices;
- The 18 electronics distributors reported $116 billion in gross receipts and paid only $654 million, or one half of 1 percent, in Federal income tax;
- Only nine electronics companies reported positive taxable income;
- Eight of the automobile and motorcycle companies paid no federal income tax and IRS has proposed $2.5 billion in adjustments to income;
- A foreign parent sold television sets to an unrelated distributor for $150, while its subsidiary paid $250 for the same model;
- One foreign automobile manufacturer sold cars to its U.S. distributor at prices averaging $800 more than identical cars shipped to its Canadian distributor.

Source: House Ways and Means Committee
Based on Internal Revenue Service data.

Japan, over fifty percent of which is in autos and auto parts.[27] Furthermore, the problem is likely to worsen. The Office for the Study of Automotive Transportation at the University of Michigan predicts that the automobile and auto parts trade deficit with Japan will widen from 31.1 billion dollars in 1990 to 45.7 billion dollars in 1994 in current dollars.[28] Japanese automotive companies have a clear predisposition towards importing parts from Japan for assembly in the United States. Edward M. Graham and Philip R. Krugman, fellows at the Institute for International Economics, have concluded that United States based Japanese manufacturing operations are three times as likely to import parts from Japanese suppliers for assembly in the United States than the average foreign-controlled affiliate does from its domestic suppliers.[29] Reports published during President Bush's January 1992 trip to Japan indicated that corporate Japan will increase the output at its United States transplants by roughly fifty percent in the next two or three years.[30] Economist Clyde Prestowitz of the Economic Strategy Institute calculates that the net impact of Japanese auto transplants has been a loss of about eighty-three thousand jobs and 6.3 billion dollars in gross national product.[31]

Available evidence suggests that either Japan Inc. is committing tax evasion on a massive scale or it does not know the value of the goods and services it produces. Japan Inc. has earned steadily increasing revenues in the United States during 1983 to 1987, yet produced an anomalous decrease in net income during the same period. [*See* Chart #3]. A congressional study of IRS tax return data concluded that foreign subsidiaries of United States companies operating abroad "generally earn at 8 to 10 percent pretax net operating profit on their business receipts," while United States subsidiaries of companies from Japan, Canada, United Kingdom and West Germany operating in the United States earned only 0.1 percent on receipts, hardly a reason to do business here.[32]

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27. SEAN P. MCALINDEN ET AL., THE UNIV. OF MICHIGAN TRANSP. RESEARCH INST., Report No. UMTRI 91-20, THE U.S.-JAPAN AUTOMOTIVE BILATERAL 1994 TRADE DEFICIT 2 (1991).

28. *Id.* at 72.

29. EDWARD M. GRAHAM & PAUL R. KRUGMAN, INST. FOR INTERNAT'L ECONOMICS, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES 78 (2d ed. 1991).

30. David E. Sanger, *Trade Mission Ends in a Tense Meeting About Autos*, N.Y. TIMES, Jan. 10, 1992, at A1, A11.

31. CLYDE PRESTOWITZ ET AL., ECONOMIC STRATEGY INST., THE CASE FOR SAVING THE BIG THREE 2 (1992).

32. *Tax Underpayments*, *supra* note 14, at 96 (testimony of Charles S. Triplett, Deputy Assoc. Chief Counsel, IRS).

A separate study of federal corporate income tax returns from 1980 to 1987 found various reasons for the low rate of return for foreign corporations in the United States. The authors of the study found, for example, that one-half of the difference in profitability could be explained by a maturation process that all foreign corporations undergo in the United States market, or by exchange rates having a significant effect on foreign corporations' profitability, or by asset revaluation distorting the ratio of taxable income to assets, or, finally, by the effect on profits of outside purchases and investment income. The authors, however, concluded that the other half of this profitability differential was unable to be explained "by forces other than transfer pricing."[33] Whatever the actual tax revenue loss, transfer pricing appears to have effectively subsidized Japanese entry into United States markets at the expense of American business interests.

Lack of an effective IRS response to international transfer pricing abuses either represents a triumph of diplomatic nicety over evenhanded enforcement of the nation's revenue laws or, more likely, shows that IRS is seriously outgunned. As of February 1990, the IRS was handling 294 cases of transfer pricing abuses involving proposed income adjustments of over thirteen billion dollars.[34] Congressional testimony refers to press accounts that seventeen Japanese companies—including the Daiichi-Kangyo Bank, NEC, Nissan, Sony America and Yamaha USA—have

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33. The study, which used Treasury Department data, analyzed the federal corporate income tax returns (IRS form 1120) for the year 1987 of a cross section of 4000 domestically-controlled and 600 foreign-controlled corporations (excluding finance, insurance, and real estate corporations). In addition, the authors constructed a second data set, called a panel, using IRS Form 1120 data from 1980 to 1987 for firms with assets of $50 million or more. The panel data set included about 1300 domestically-controlled firms and 110 foreign-controlled firms. According to the authors, the panel was valuable in identifying the role of startup costs and exchange rates in evaluating the profits of foreign and domestic corporations. Measuring return on investment as the ratio of taxable income over assets, the ratio was only 0.58 for foreign-controlled companies compared with 2.14 for domestically-controlled companies in 1987. The authors of the study also analyzed the returns of 86 Japanese companies in a cross section of 528 foreign-controlled companies. According to the study, corporate Japan's 1987 profitability taxable income/assets ratio is -0.025 and, the authors noted, its debt/assets ratio is 0.097 which is a full 10 percentage points higher than domestically-controlled companies. Timothy Goodspeed et al., *Explaining the Low Taxable Income of Foreign Controlled Companies in the United States 1, 2, 4-6, Tables 1.1 and 2.4* presented at the Conference on the International Aspects of Taxation, Cambridge; National Bureau of Economic Research, Inc. (Sept. 28, 1991).

34. *Tax Underpayments, supra* note 14, at 53 (statement of Patrick G. Heck, Assistant Counsel, Subcomm. on Oversight, Comm. on Ways and Means).

BOX NO. 2

SONY'S 1989-1990 BOX SCORE

The Sony 20-F SEC filings disclosed the following for the years ended 1989 and 1990 (in thousands of dollars and percentage):

	Sony Corporation			
	1989		1990	
Sales:				
Japan	$5,540,129	34.1%	$5,538,077	30.2%
U.S.	4,441,500	27.3	5,463,771	29.8
Europe	3,771,530	23.2	4,556,828	24.8
All Other	2,499,333	15.4	2,784,356	15.2
Total	$16,252,492	100.0%	$18,343,032	100.0%
Income before Taxes::				
Japan	775,689	61.9%	$996,293	68.8%
Foreign	478,220	38.1	452,299	31.2
Total	$1,253,909	100.0%	$1,448,592	100.0%
Income Taxes Current:				
Japan	$491,614	71.2%	$568,866	69.8%
Foreign	198,757	28.8	246,529	30.2
Total	$690,371	100.0%	$815,395	100.0%

Sony is representing that in 1989 and 1990 sales in Japan by the Japanese parent and its domestic subsidiaries generated 32% of total sales, 65.6% of pre-tax income and 70.4% of income tax payments. Or in other words, foreign sales (i.e., sales of the foreign subsidiaries of Sony) of 68% generated only 34.4% of the income before tax and only 29.6% of 1989 and 1990 tax payments. Sony has stated publicly that its tax returns have been prepared in compliance with IRS regulations and that IRS routinely has audited those returns.

Source: House Ways and Means Committee and Sony's 20-F SEC filings for 1989 and 1990

been under IRS investigation for transfer pricing abuses.[35] Since IRS administrative proceedings are confidential, these reports cannot be verified. Tax court dockets disclose only litigation against Yamaha,[36] as of March 1992. IRS claims that Yamaha underreported its income and underpaid income taxes by a total of $133 million from 1977 to 1984, and is attempting, as well, to collect $13 million in assessed penalties.[37]

Not every low-performing, foreign-controlled corporation engages in tax evasion through transfer pricing. For example, concluding solely from Sony's 1989 and 1990 SEC filings that the company has engaged in tax evasion through transfer pricing could be unfair, even though goods sold abroad by Sony's foreign subsidiaries earned approximately two-thirds of pretax income, but accounted for less than one-third of income taxes paid. [*See* Box #2]. No two industries are alike. Firms within an industry may do business in very different ways. Conceivably, interest and depreciation, costs often associated with startups, or fluctuations in exchange rates, could account for the low tax rates of a given foreign owned company. Perhaps a particular Japanese company was less profit driven due to the low cost of capital.

Suggested responses to the problem have focused on governmental action. Graham and Krugman believe that widespread transfer price manipulation could represent an "important additional cost" of foreign direct investment in the United States, such that those who evaded taxes through transfer schemes should be "prosecuted to the full extent of the law."[38] Prestowitz summarizes the pernicious effect of transfer pricing abuses as follows:

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35. *Id.* at 298 (statement of Rep. Duncan Hunter from California).

36. Yamaha Motor Corp. U.S.A. and Subsidiaries v. Commissioner, No. 2674-88 (T.C. filed Feb. 11, 1988). ***The Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income***, Mar. 8, 1971, U.S.-Japan, 23 U.S.T. 969, T.I.A.S. 7365 (1971), *reprinted in* 1973-1 C.B. 630 (hereinafter "*Convention on Double Taxation*") may account for the lack of court action on transfer pricing cases involving "inbound" products. The *Convention on Double Taxation* gives a taxpayer the option to elect an arbitration procedure in which competent United States and Japanese tax authorities participate, "notwithstanding the remedies provided by the national laws of the contracting states." *Id.*, art. 2(f) & art. 25; Rev. Pro. 91-23, 1991-11 I.R.B. 18 *as clarified by* Rev. Pro. 91-26, 1991-17 I.R.B. 7. Corporations elect this arbitral process so often that "inbound" transfer pricing cases rarely see the light of day through litigation. Whether the *Convention on Double Taxation* provides an alternative means of dispute resolution or a mandatory condition precedent to IRS-initiated transfer price litigation is beyond the scope of this Article.

37. Robert Pear, *Investigating Foreign Companies For Tax Cheating,* N.Y. TIMES, Feb. 18, 1990, at A1.

38. GRAHAM & KRUGMAN, *supra* note 29, at 82-83.

> Components imported by the transplants from their parent companies in Japan are priced at levels almost equal to the cost of the completed vehicle imported fully built-up from Japan. This results in a significant profit drain from the United States entity in favor of the Japanese parent company.
>
> * * *
>
> As a consequence, United States operations have incurred huge losses with a proportionate surge in Japanese profits. No taxes are paid in the United States because of the large loss carry forwards booked by the transplants.
>
> * * *
>
> Behind this phenomenon is the *keiretsu* structure of Japanese industry. . . .[39]

To counter these practices, Prestowitz urges continuous IRS audits of *keiretsu* transfer pricing.[40] Increased IRS scrutiny would serve the interest of recouping lost tax dollars and would have an important deterrent effect. IRS activity, however, would produce no tangible result for American businesses already harmed by transfer pricing abuses.

V. RICO's Terrible Swift Double-Edged Sword

Conventional wisdom holds that the private sector has no remedy for injury- producing tax evasion or other *keiretsu* practices. The only time that a reported federal court opinion even mentioned the word "*keiretsu*" was during the 1981 to 1983 "television cases," which attempted unsuccessfully to use the antitrust laws to counter collusive Japanese business practices.[41] What is needed for a wrong perceived to be beyond the law is a solution not bounded by convention. Only RICO could provide a means for American companies injured by these practices to take matters into their own hands and recover compensation for damages sustained from any provable *keiretsu* tax evasion scheme. RICO should only be used in this way as a response to evidence that tax evasion through transfer pricing formed a conscious and effective part of an exploitative business strategy of a particular Japanese company.

Enacted in 1970, RICO has proven to be the most powerful law ever used against organized crime. Mafia trials around the country—in New

39. Prestowitz, *supra* note 31, at 57.

40. *Id.* at 113.

41. Although the subject is beyond the scope of this Article, RICO and mail fraud may be a possible response to some *keiretsu* anticompetitive practices beyond the reach of the antitrust laws and that do not necessarily involve tax evasion. *See* United States v. Ames Sintering Co., 927 F.2d 232 (6th Cir. 1990) (prosecution under 18 U.S.C. § 1343).

York, Chicago, Kansas City, and Boston—as well as the government's successful effort to impose court supervision on the Teamsters Union and other labor unions, attest to its effectiveness.

The source of RICO's potency, at least partly, is that under RICO, the "pattern" of criminal activity is the crime. By using a common sense approach to the nature of organized crime—that is, collective criminality to further institutional Mafia interests rather than isolated crime committed for individual gain—RICO makes it a criminal offense to "engage in a pattern of racketeering activity,"[42] the very lifeblood of Mafia enterprise. RICO's application is not limited to organized crime[43] as Drexel Burnham and Michael Milken found out.[44]

Crimes prosecuted as part of a RICO pattern must include two or more specific criminal offenses, among them mail and wire fraud and money laundering.[45] Each mailing and wire transmission used in furtherance of a scheme to defraud and each money laundering transaction is a separate racketeering act. *Ipso facto* RICO's pattern materializes when two or more such offenses are linked in a way which transgresses RICO's bar against institutionalized crime.[46]

RICO does more than simply define criminality. RICO provides victims of racketeering with the civil right to hold racketeers accountable, whether or not they are certified mobsters. In the tradition of victims' rights, RICO permits those injured by a "pattern of racketeering activity" to recover treble damages and collect attorneys fees.[47] This monetary triple threat openly encourages private attorneys general[48] to police the mob, or those who behave like the mob.

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42. 18 U.S.C.A. § 1961(5) (West 1984 & Supp. 1991).

43. *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 495 (1985); *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229 (1989).

44. William Glaberson, *Racketeering Cases Are Popping Up in Several Varieties*, N.Y. Times, Feb. 18, 1990, at D6.

45. 18 U.S.C.A. § 1961(1)(B) (West 1984 & Supp. 1991).

46. In general, the elements of a RICO claim are as follows:

> (1) that the defendant (2) through the commission of two or more acts (3) constituting a "pattern" (4) of "racketeering activity" (5) directly or indirectly invests in, or maintains an interest in, or participates in (6) an "enterprise" (7) the activities of which affect interstate or foreign commerce.

Moss v. Morgan Stanley, Inc., 719 F.2d 5, 17 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984). A threat of continued racketeering must also be present. *See* H.J. Inc. v. Northwestern Bell Tel. Co., 492 U.S. 229, 239 (1989).

47. 18 U.S.C.A. § 1964(c) (West 1984 & Supp. 1991).

48. *See* Agency Holding Corp. v. Malley-Duff & Assoc., Inc., 483 U.S. 143, 151 (1987) (RICO "bring[s] to bear the pressure of 'private attorneys general' on a serious national problem for which public prosecutorial resources are deemed inadequate.").

The civil side of RICO's two-edged sword is every bit as sharp as its criminal edge. Unfortunately, business has often found itself on the receiving end of nuisance civil RICO cases which accounts for much of its ongoing campaign to lobby for changes in RICO's civil side. On occasion, though, RICO exposure can be terminal. Hundreds of millions of dollars may be at stake, for example, when a public utility is alleged to have committed fraud during the utility rate making process.[49] The principle at work in the utilities cases also underlies the *keiretsu* tax evasion model—RICO can redress the fraudulent subversion of governmental processes.

Business' anti-RICO lobbying efforts do not take into proper account RICO's positive side. For example, IBM, in its well-known civil case against Hitachi, used RICO (with a notable assist from an FBI undercover investigation) to collect reportedly 300 million dollars in damages after the Japanese firm pleaded guilty to stealing IBM trade secrets.[50]

VI. RICO and *Keiretsu* Tax Evasion

RICO can be just as effective where the issue is not industrial espionage, but tax evasion. To use RICO in the *keiretsu* setting, two criteria must be met: first, a Japanese company must have sold products or services at higher than their real market value to a related United States company and, second, this must have been done, at least in part, with the intention to evade the payment of federal or state income taxes that would have been due otherwise had these products or services been priced at their true market value.

2 elements

To understand the law's application in this setting, the assumed components of a tax evasion scheme must be reduced to their simplest terms. A foreign parent company provides goods or services to a related United States based entity at artificially high prices, thereby reducing United States taxable income. The entity transfers funds to the Japanese parent to pay for those goods or services, files corporate tax returns and then pays lower United States taxes as a result of the shift of profit from the

49. *See, e.g.*, Taffet v. Southern Co., 930 F.2d 847 (11th Cir. 1991); County of Suffolk v. Long Island Lighting Co., 710 F. Supp. 1405 (E.D.N.Y. 1988), *aff'd in part and rev'd in part*, 907 F.2d 1295 (2d Cir. 1990).

50. *See* International Business Machines Corp. v. Hitachi Ltd., No. C-82-4976 (N.D. Cal. filed Sept. 16, 1982); United States v. Nakazawa et al., No. 184 MB (N.D. Cal. filed June 22, 1982); United States v. Kanzuma, No. 187 MB (N.D. Cal., filed June 22, 1982). Mike Van Deelen, Analyst for Ranscher Pierce Refshes, Inc., Investext Report No. 400510 (Dec. 6, 1983) *available in* LEXIS, Company Library, RPR File. Court records, however, did not reveal the precise settlement terms.

United States to Japan. American competitors are placed at a disadvantage and are hurt in some quantifiable way. If these assumptions are proved true in a given case, then RICO's "pattern of racketeering activity" would consist of mail or wire fraud and money laundering violations.

Mail or wire fraud is simply a scheme to defraud furthered by the use of the mails or wire transmission.[51] In the *keiretsu* model, the United States government and American businesses are generally both the intended and actual victims of this racketeering scheme. The IRS loses tax dollars and businesses lose market share and profits.

Money laundering is the conduct of[52] or attempt to conduct:[53] financial transactions involving the proceeds of specified unlawful activity[54] (in this instance, mail or wire fraud); the international transportation of the proceeds;[55] or monetary transactions in property constituting or derived from the proceeds of a criminal offense.[56] The profit-shifting (representing fraudulently concealed taxable income) from a foreign controlled corporation to Japan, Inc. could be viewed as laundering transactions and transportation. Using RICO this way privatizes enforcement of public tax policy, a controversial and untested idea.[57]

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51. 18 U.S.C.A. §§ 1341, 1343 (West 1984 & Supp. 1991).

52. 18 U.S.C.A. § 1956(c)(2) (West 1984 & Supp. 1991).

53. 18 U.S.C.A. §§ 1956(a)(1)-(2), 1957(a) (West 1984 & Supp. 1991).

54. 18 U.S.C.A. §§ 1956(a), (c)(7) (West 1984 & Supp. 1991).

55. 18 U.S.C.A. § 1956(a)(2).

56. 18 U.S.C.A. § 1957(a).

57. Using civil RICO to address federal income tax evasion unquestionably is novel. The Fourth, Seventh, Eighth, and Ninth Circuits appear prepared to permit the use of RICO premised on mail or wire fraud in tax fraud cases. *See* United States v. Computer Sciences Corp., 689 F.2d 1181, 1187-88 n.13 (4th Cir. 1982), *cert. denied*, 459 U.S. 1105 (1983); United States v. Miller, 545 F.2d 1204, 1216 n.17 (9th Cir. 1976), *cert denied*, 430 U.S. 930 (1977); United States v. Mirabile, 503 F.2d 1065, 1066-67 (8th Cir. 1974), *cert. denied*, 420 U.S. 973 (1975); United States v. Flaxman, 495 F.2d 344, 348-49 (7th Cir.), *cert. denied*, 419 U.S. 1031 (1974). The Second Circuit called it a "disputed issue." United States v. Regan, 937 F.2d 823, 827 (2d Cir. 1991). *But see* United States v. Porcelli, 865 F.2d 1352 (2d Cir. 1989) (affirming RICO conviction premised on state tax evasion).

United States Department of Justice policy permits the use of RICO in criminal tax fraud cases if "exceptional circumstances" exist "when individuals, through no deliberate fault of their own, were demonstrably victimized as a result of a defendant's fraudulent scheme and use of a [RICO] mail fraud charge is necessary to achieve some legitimate, practical purpose like securing restitution for the individual victims." DEPARTMENT OF JUSTICE MANUAL § 6-4.211(1) (Supp. 1990-1). This is the precise effect of a *keiretsu* tax evasion scheme.

Even if civil RICO does not give victims a remedy for federal income tax fraud, no

VII. Intent is the Key

The most difficult element to prove in the *keiretsu* transfer pricing context would be state of mind or intent. The key question would be: Did the transfer pricing have an economic justification, or was it intended to shift profits out of the United States for the purpose of reducing taxable income? Any willful failure to report income, knowing it was taxable or possessing an intent to evade taxes and defraud the government would establish this type of RICO violation.[58]

In any RICO transfer pricing case, the issue of intent would first turn on whether the transfer price was too high. A *keiretsu's* deliberate decision not to use market value (which the IRS judges by what it calls the "arms length" standard)[59] in establishing transfer price makes a compel-

such limitation exists with respect to state tax fraud. United States v. De Fiore, 720 F.2d 757 (2d Cir. 1983), *cert. denied*, 467 U.S. 1241 (1984); United States v. Brewer, 528 F.2d 492 (4th Cir. 1975); United States v. Melvin, 544 F.2d 767 (5th Cir.), *cert. denied*, 430 U.S. 910 (1977); Illinois Dep't of Revenue v. Phillips, 771 F.2d 312 (7th Cir. 1985); United States v. Mirabile, 503 F.2d 1065 (8th Cir.), *cert. denied*, 420 U.S. 973 (1975). Since a *keiretsu* tax evasion scheme is likely to have state tax authorities as ancillary victims, as well as the IRS, RICO's applicability to federal income tax fraud is of little consequence. All that matters is that tax evasion (whether federal or state) injured a United States company. *See also* G. Robert Blakey & Thomas A. Perry, *An Analysis of the Myths That Bolster Efforts to Rewrite RICO and the Various Proposals for Reform: "Mother of God—Is This the End of RICO?"*, 43 Vand. L. Rev. 851, 908 n. 153 (1990) ("Retailers that have to compete with tax cheating competitors are put at a substantial and often disabling competitive disadvantage. This problem also implicates RICO's core concerns. Unfair competition, rooted in the profits of illegal behavior, goes to RICO's basic rationale.").

Some states tax multinational corporations based on profits derived from within the state. Graham & Krugman, *supra* note 29, at 135. Others, such as California, Florida, New York, and Massachusetts, utilize what is known as a "worldwide unitary taxation" formula permitting taxation of profits from in-state operations wherever derived. *Id.*; Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983). Under either approach, deliberate understatement of income through transfer pricing abuses could result in evasion of state income taxes.

58. *See* United States v. Bishop, 412 U.S. 346, 360-61 (1973); United States v. Gelb, 700 F.2d 875, 879 (2d Cir.), *cert. denied*, 464 U.S. 853 (1983); *see also* 18 U.S.C.A. §§ 1341, 1343, 1956(1)(A)(ii); I.R.C. §§ 7201, 7206 (West 1988).

59. The Internal Revenue Code allows the IRS to allocate income deductions between commonly controlled taxpayers "to prevent evasion of taxes or clearly to reflect the income" of those taxpayers. I.R.C. § 482 (West 1988). The standard used for making those allocations is called the arm's length method, that is, an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Treas. Reg. § 1-482-1(b)(1) (1990). Under the regulation, a "controlled" taxpayer means "any one of two or more organizations, trades or businesses owned or controlled directly or indirectly by the same interests". Treas. Reg. § 1.482-1(a)(4).

ling case for an intent to evade taxes. Paradoxically, a RICO transfer pricing case would turn on the purposeful use of a false valuation, a simple fact, though not so simple to prove. It would not turn on the complex tax formulation used in IRS transfer pricing civil audits, which seeks to allocate taxable income between a foreign parent and its United States subsidiary. In any event, these income allocation methods are intended "to prevent evasion of taxes," not to be used as a means to commit tax evasion.[60]

False book entries or alterations, phony invoices, a consistent pattern of under-reporting large amounts of income,[61] or any conduct likely to mislead or conceal,[62] would justify an inference that the purpose was to evade taxes. That transfer pricing did, in fact, reduce United States taxable income also would be relevant evidence of intent. Laundering profits through third country tax havens also would tend to prove a tax evasion motive.[63]

The IRS uses four methods to determine the appropriate transfer price: the controlled price method based on comparable sales, the resale price method based on an appropriate resale profit margin, the cost profit method based on a cost plus analysis, and a residual category, usually based on financial ratios such as return on equity, when the first three methods do not apply. Treas. Reg. § 1.482-2(e)(1)-(4) (1990); *see, e.g.*, Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), *aff'd in part and rev'd in part*, 856 F.2d 855 (7th Cir. 1988).

On January 27, 1992, the Treasury Department proposed new transfer pricing regulations that clarify the arm's length standard as follows:

> In determining whether controlled taxpayers have dealt with each other at arm's length, the general principle to be followed is whether uncontrolled taxpayers, each exercising sound business judgment on the basis of reasonable levels of experience (or, if greater, the actual level of experience of the controlled taxpayer) within the relevant industry and with full knowledge of the relevant facts, would have agreed to the same contractual terms under the same economic conditions and other circumstances.

The proposed regulations added the following definitions:

> 1.482-1(a)(4) The term "uncontrolled taxpayer" means any one of two or more organizations, trades, or businesses not owned or controlled directly or indirectly by the same interests.
>
> (5) The terms "uncontrolled group" and "group of uncontrolled taxpayers" means the organizations, trades, or businesses not owned or controlled directly or indirectly by the same interests.

Prop. Treas. Reg. § 1.482-1(b)(1) *available in* LEXIS, Fedtax Library, TNT File. The comment period on the proposed regulations ends May 31, 1992.

60. I.R.C. § 482 (1988).

61. *See* United States v. Gardner, 611 F.2d 770 (9th Cir. 1980).

62. *See* Spies v. United States, 317 U.S. 492, 499 (1943).

63. The precise direct monetary benefit to Japan Inc. of a transfer pricing scheme could be determined through an analysis of the ultimate repatriation of the laundered

VIII. The Long Arm of RICO

United States courts have jurisdiction over United States subsidiaries of foreign companies, but the issue is whether RICO can reach the Japan-based controller of a *keiretsu* tax evasion conspiracy. In other words, do United States courts have jurisdiction over the Japanese parent corporation or partner? RICO can reach beyond United States borders through a principle of international law known as extraterritorial jurisdiction,[64] but only if some racketeering activity took place or had a substantial effect in the United States.[65] RICO's global reach is particularly clear when racketeering involves money-laundering because Congress explicitly gave federal anti-money laundering laws an international scope.[66] Therefore, the foreign parent of a United States subsidiary could be a defendant in a civil RICO action. Similarly, relevant information may be secured from the Japanese parent of a United States-based subsidiary through the discovery provisions of the Federal Rules of Civil Procedure since the court would have *in personam*[67] jurisdiction over the

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taxable income to Japan or its subsequent use outside of Japan. Tax treatment in Japan of such funds repatriated through a third nation is beyond the scope of this Article.

64. James D. Harmon, Jr., *United States Money Laundering Laws: International Implications*, 9 N.Y.L. Sch. J. Int'l & Comp. L. 1, 18-23 (1988).

65. Alfadda v. Fenn, 935 F.2d 475 (2d Cir. 1991) (subject matter jurisdiction); *see also* 18 U.S.C.A. § 1965.

Congress enacted § 6038(C) to give the IRS the power to force foreign parent corporations to produce records dealing with transfer pricing. I.R.C. § 6038(C) (West 1990). *See* H.R. Rep. 881, 101st Cong., 2d Sess., 318-20 (1990), *reprinted in* 1990 U.S.C.C.A.N. 2017, 2320-32. This creates no independent private right to secure these records. RICO does not provide for international service of process. Jurisdictional issues with respect to the production of documentary materials located outside of the United States is beyond the scope of this Article.

66. 18 U.S.C.A. §§ 1956(f), 1957(d) (West 1984 & Supp. 1991).

67. Courts find *in personam* jurisdiction over foreign parents of United States subsidiaries, branches, or agencies by virtue of the parent's activities in the United States. Matter of Marc Rich & Co., A.G., 707 F.2d 663 (2d Cir. 1982), *cert. denied* 463 U.S. 1215 (1983); In re Grand Jury Proceedings, 691 F.2d 1384 (11th Cir. 1982), *cert. denied sub nom* Bank Of Novia Scotia v. U.S., 462 U.S. 1119 (1983); United States v. Toyota Motor Corp., 561 F. Supp. 354 and 569 F. Supp. 1158 (C.D. Cal. 1983). Effective service was made on the subsidiary or branch office in the United States in these cases.

Courts first determine whether there is statutory authority for the *in personam* jurisdiction. In a transfer price audit IRS sought certain books and records located in Japan. Service on Toyota, Japan was made on Toyota, U.S.A. in California. The court concluded that Toyota Japan could be "found" within the meaning of the IRS service of process statute, I.R.C. § 7604(a), for jurisdictional purposes in Torrance, California, where its subsidiary was located. *Toyota Motor Corp.*, 561 F. Supp. at 357. According to

foreign parent, or through letters rogatory.[68]

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press reports, IRS claimed that Toyota together with Nissan Motor Corp. owed one billion dollars in federal income taxes. Toyota and Nissan reportedly settled for hundreds of millions of dollars to be paid to IRS. Both Toyota and Nissan were reportedly reimbursed by the Japanese government for the deficiency. *Japan, U.S. Agree to Prevent Double Taxation*, Japan Economic Newswire, Oct. 31, 1988 *available in LEXIS*, Nexis Library, Jeni File; Gary Klott, *Texaco Case Part of Growing Crackdown*, N.Y. TIMES, Jan. 15, 1988, p.4.

RICO's service of process provision contains language similar to that of I.R.C. § 7604(a), which was at issue in *Toyota Motor Co.* RICO process "may be served on any person in any judicial district in which such person resides, is found, has an agent, or transacts his affairs." 18 U.S.C.A. § 1965(d). Given RICO's purposefully broad scope, its public interest function and its role as an adjunct to law enforcement, courts should resolve *in personam* jurisdictional issues in RICO transfer pricing as they have done in criminal, grand jury and IRS summons enforcement proceedings. *E.g.*, Matter of Marc Rich & Co., A.G.; In re Grand Jury Proceedings. Service on the United States subsidiary in the United States should be sufficient regardless of its status as a distinct corporate entity. Toyota Motor Co., 561 F.Supp. at 360.

Due process permits such an approach with respect to U.S. based *keiretsu* operations. *See* Lisak v. Mercantile BanCorp., Inc., 834 F.2d 668, 672 (7th Cir. 1987) (RICO contains an explicit grant of nationwide service which does not violate the Due Process clause). A foreign corporation that has purposefully delivered "its products into the stream of commerce with the expectation that they will be purchased by consumers" in the United States is within the jurisdiction of its courts. World-Wide Volkswagen Corp. v. Woolson, 444 U.S. 286, 297-98 (1980).

Such jurisdiction may be defined as either "general" or "limited" depending upon how substantial and systematic the contacts are with the forum. General jurisdiction permits *in personam* jurisdiction even if the cause of action is unrelated to the defendant's forum activities. Limited jurisdiction arises from activity in the forum related to the cause of action. Data Disc., Inc. v. Systems Technology Associates, Inc., 557 F.2d 1280, 1287 (9th Cir. 1977); Wells Fargo & Co. v. Wells Fargo Express Co., 556 F.2d 406, 413 (9th Cir. 1977). Contacts with the United States, not any individual state, should be determinative. *See* Marc Rich & Co., A.G., 707 F.2d at 667 (The court did not examine New York's long arm statute because "[t]he subject of the grand jury's investigation is the possible violation of federal revenue statutes, and the right to inquire of appellant depends upon appellant's contacts with the entire United States, not simply the State of New York"). *Toyota Motor Corp.* found limited jurisdiction in the "purposeful exploitation of the forum by Toyota, Japan." 561 F. Supp. at 359. The court concluded that "there is no obstacle to jurisdiction over the foreign parent if it uses its subsidiary as a marketing conduit." *Id.* United States courts should exercise jurisdiction under either theory—limited or general jurisdiction—when faced with transfer pricing abuses linked to access to United States markets.

68. A letter rogatory is a formal request by a United States court to a foreign court seeking the performance of some judicial act. James P. Springer, *An Overview of International Evidence And Asset Gathering in Civil and Criminal Tax Cases*, 22 GEO. WASH. J. INT'L L. & ECON. 277, 312 (1989). The procedure is fraught with time delays and dependent upon foreign and domestic bureaucracies and foreign judicial procedures over which the United States courts and litigants have no control. *Id.* at 312-13. The

IX. Damages and Proof

Proving a RICO violation, predicated upon tax fraud through transfer pricing is only half the battle. An American competitor still must prove that it sustained, either directly or indirectly, damages "by reason of" a tax evasion racket.[69] The Supreme Court recognizes that RICO damages include "competitive injury,"[70] or as Justice Marshall explained it, loss to "competitors and investors whose businesses and interests are harmed . . . or whose competitive positions decline because of infiltration in the relevant market."[71] In *Sedima S.P.R.L. v. Imrex Co.*, the Supreme Court postulated at some length those scenarios that would produce "competitive injury" cognizable under RICO. These seem to anticipate application to *keiretsu* racketeering as follows:

> If a "racketeer" uses "[t]hreats, arson and assault [or other racketeering conduct] . . . to force competitors out of business and obtain larger shares of the market" . . . [t]he pattern of those acts is designed to accomplish, and accomplishes, the goal of monopolization. Competitors thereby injured or forced out of business could allege "RICO" injury and recover damages for lost profits.
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> * * *
>
> [I]f the enterprise conducts its business through a pattern of racketeering activity to enhance its profits or perpetuate its economic power, competitors of that enterprise could bring a civil RICO action alleging injury by reason of the enhanced commercial position the enterprise has obtained from its unlawful acts . . . .
>
> * * *
>
> Alternatively, if the infiltrated business operates a legitimate business to a businessman's disadvantage because of the enterprise's strong economic base derived from perpetration of predicate acts, the competitor could bring civil RICO action alleging injury to his competitive position.[72]

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letters rogatory process has been streamlined and standardized in civil and commercial disputes by the *Convention on the Taking of Evidence Abroad in Civil & Commercial Matters, opened for signature* Mar. 18, 1970, 23 U.S.T. 2555, T.I.A.S. No. 7444, *reprinted in* USCS Conventions, Taking Evidence Abroad Conv. (1983). To date, Japan is not a signatory to that convention.

69. 18 U.S.C.A. § 1964(c).

70. Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 497 n.15 (1985); *see also*, Holmes v. Securities Investor Protection Corp., No. 90-727, 1992 WL 52846, at *8 n.20 (U.S. Mar. 24, 1992) (plaintiffs may recover damages under RICO for injury proximately caused by the defendant, which determination is made on a case by case basis). In a concurring opinion, Justice Scalia proposed a "zone of interests" test that would "vary according to the nature of the criminal offenses upon which those causes of action are based." *Id.* at *14.

71. *Sedima*, 473 U.S. at 519 (Marshall, J., dissenting).

72. *Id.* at 521-22 (Marshall, J., dissenting). The majority in *Sedima* adopted a broader view, concluding that recoverable RICO damages include "but are not limited to, the sort of competitive injury for which the dissenters would allow recovery." *Id.* at 497, n. 15.

BOX NO. 3

A SMOKING GUN

What follows is a copy of a FAX to a Japanese parent automobile company from a U.S. subsidiary responding to a complaint from the parent that the subsidiary was making too much profit in the U.S.

(TRANSLATION)

[redacted]

[redacted] - (illegible)

[redacted]

[redacted]

To: [redacted]

Dated: Dec. 28, '82.

From: [redacted]

Subject: Price of 83 Models (file)

Re 12/28 fax from Overseas Sales Division.

The kind of letter which one doesn't care to read so close to the year's end or that something which one has always been fearing might happen, has finally arrived.

[redacted] announcement that it was expecting increased earnings for next term (or this term, more correctly speaking), gives us the impression that it is determined to maximize profits in the U.S. market. Apparently, [redacted] has a strong aversion to the [redacted] companies making excessive profits. This was expressed quite clearly by Mr. [redacted] who told us quite bluntly that the biggest problem with [redacted] is that we are making too much profit. Mr. [redacted] also relayed to us a message from Mr. [redacted] that he wanted us to sell more trucks. Any way, frankly speaking, we cannot understand why they have sent us this long fax.

In the past one year, we have been screaming at them every time they wanted to raise the prices. Is this a sort of pre-emptive strike to discourage our attempt to obtain a price reduction? Or are they proposing it to [redacted] importers? I have not had a chance to talk with [redacted]. In the meantime, I am still wondering how I should respond. If you have any suggestions, please let me know.

In other woreds, they are telling us that they will not talk about any price reduction and that we should put up with the deficit and spend money for sales promotion of trucks.

Should we just meekly do what we are told to do without complaining or should we assert that we believe to be right? Please give us your guidance on this point.

At least, we would like to reserve to ourselves the right to raise the retail price to maintain our profitability.

We plan to call on [redacted] in early March, the reason being:

1) That our '82 earnings and the '83 January earnings are expected to be positive, which make our presentations less convincing. Besides, our presentation materials won't be ready until after the end of January.

2) Both sides are likely to be very busy.

3) It may be better to go in March with the deficit figures of February in hand.

Your comments are invited.

We would like to take this opportunity to thank you for your cooperation throughout the year and wish you a happy New Year. Say hello to all.

Sincerely,

P.S. The seal on the fax is that of Mr. [redacted] or of Mr. [redacted]. It's illegible.

The FAX, written in Japanese, was given to the IRS by the subsidiary which claimed it meant nothing. Upon translation, IRS concluded that its purpose was to increase earnings in Japan by raising the transfer price of cars to the United States. Any such FAX or memo would be evidence of a tax evasion intent because the transfer price was set without any regard to the intrinsic value of the cars sold to the U.S. subsidiary. The identities of the companies involved have not been disclosed.

Source: House Ways and Means Committee and Internal Revenue Service

The measure of damages could be gain to any proven tax evader computed as enhanced revenues or, possibly, loss to the IRS resulting from a *keiretsu* tax scheme, or consequent loss to a particular American business. Consistent with the "express admonition that RICO is to 'be liberally construed to effectuate its remedial purposes,' "[73] ultimate recovery could be multiples of lost tax dollars. Little beyond this is certain. RICO damages theory is early in its evolution with little precedent. Theory is one thing; proof quite another. As is true in any case, a RICO violation may be proven by either direct or circumstantial evidence. The best cases would rely on both. The primary facts to be proven would be the tax evasion scheme of Japan Inc. and its United States based subsidiary and competitive injury sustained as a result of racketeering, not some other cause like management incompetence or product inferiority.

Direct evidence is likely to come only from insiders or former insiders. Whistleblowers may come forward given the incentive from federal bounty hunter laws of sharing on a percentage basis (possibly up to twenty-five percent) in any recovery to the IRS resulting from detection of a transfer pricing tax evasion scheme.[74] The existence of a single memorandum, or its destruction or alteration, could prove devastating. [See Box #3] Sophisticated investigative techniques may be required to develop such evidence before the commencement of a case, because pretrial discovery remains the only other, less efficient, option for developing insider information.

Given the government's tight control over information held by the IRS,[75] alternative means must be used to determine the tax treatment of

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73. *Id.* at 498 (quoting Pub. L. 91-452, § 904(a), 84 Stat. 947).

74. A person who provides information of tax evasion is eligible to receive a reward "normally not to exceed" ten percent of taxes, penalties, and fines then collected as a result of the information. I.R.C. § 7623 (West 1988); Treas. Reg. § 301.7623-1 (1990). One who brings a civil fraud suit for treble damages on behalf of the government under the False Claims Act based on conduct before October 27, 1986 may be entitled to 25 percent of any recovery by the government. 31 U.S.C. §§ 3729(e), 3730(d) (West Supp. 1991). A number of states have similar privateering laws.

To give more incentive to whistleblowers, Congress should amend the False Claims Act to make it applicable to post-October 27, 1986 conduct rising to the level of tax evasion in violation of I.R.C. § 7201 that is committed by foreign-controlled corporations through transfer pricing abuses.

75. IRS obtains information from three sources: taxpayers, third parties, and other tax authorities. Whether any of this information could be available to a private litigant in a civil RICO action depends on the relevant international treaty, Internal Revenue Code and Federal Rules of Civil Procedure provisions. The *Convention on Double Taxation* permits IRS to exchange information for the purpose of "preventing fraud or fiscal evasion". *Convention On Double Taxation*, *supra* note 36, art. 26(1). Through this infor-

inflated transfer prices. The most obvious source of evidence of *keiretsu*

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mation sharing process IRS may already have secured evidence of *keiretsu* transfer pricing abuses between Japanese parents and their United States subsidiaries. IRS may disclose such information in court proceedings:

> The competent authorities of the Contracting States shall exchange such information as is pertinent to carrying out the provisions of this Convention or preventing fraud or fiscal evasion in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons other than those (including a court or administrative body) concerned with assessment, collection, enforcement or prosecution in respect of the taxes which are the subject of this Convention.

Convention On Double Taxation, *supra* note 36, art. 26. The secrecy provisions of the *Convention On Double Taxation*: "[do] not prohibit disclosure in the course of a *court proceeding*" (emphasis added). Technical Explanation concerning the *Convention on Double Taxation* prepared by the Staff of the Joint Committee on Internal Revenue Taxation for the Senate Foreign Relations Committee, appended to statement by Edwin S. Cohen, Assistant Secretary of the Treasury, 1973-1 C.B. 630, 668.

Apart from the *Convention on Double Taxation*, the Internal Revenue Code provides guidelines for the disclosure of IRS information. I.R.C. § 6103(a) (West Supp. 1991) sets forth the "general rule" that "returns" and "return information", I.R.C. § 6103(b)(1), (2) (West Supp. 1991), are confidential and may not be disclosed except, *inter alia*, in a federal or state judicial or administrative proceeding "pertaining to tax administration". I.R.C. § 6103(h)(4)(A) (West Supp. 1991). *See also*, *United States v. Mangan*, 575 F.2d 32, 40 & n.9 (2d Cir. 1978) ("This language does not evidence an intention to adopt a restrictive interpretation of 'tax administration'."). At least one court has determined that I.R.C. § 6103 does not bar discovery of IRS tax information in private civil non-tax cases. *See*, *McSurley v. McAdams*, 502 F. Supp. 52, 56 (D.D.C. 1980) ("The legislative history surrounding § 6103 indicates that Congress simply never addressed the issue of access to tax information by private parties in non-tax civil cases, pursuant to court discovery orders. . .[j]udicial supervision of the discovery process will ensure that access is far from wholesale, moreover, the institution of properly tailored protective orders will minimize any resulting invasion of privacy").

Accordingly, in the event that IRS should commence a civil or criminal action which parallels a private civil RICO action, neither the *Convention on Double Taxation* nor I.R.C. § 6103 would bar disclosure of any IRS information regardless of its origins.

In the absence of such a parallel IRS-initiated action, disclosure of foreign source information would depend on whether a private civil RICO action standing alone, was found to be: (a) a court proceeding "concerned with assessment, collection, enforcement or prosecution in respect of [income taxes within the meaning of the Convention]", or (b) a federal judicial proceeding "pertaining to tax administration" within the meaning of I.R.C. § 6103, or (c) that discovery within the RICO action is permitted under the Federal Rules of Civil Procedure. Of course, disclosure of other non-foreign source information would be premised solely on meeting the requirements of I.R.C. § 6103 or the discovery provisions of the Federal Rules of Civil Procedure.

Neither the *Convention on Double Taxation* nor the Internal Revenue Code should prevent the disclosure of tax information in a private civil RICO action premised on transfer price manipulation. By definition, such a civil RICO action requires proof of tax evasion. Therefore, it is "concerned with" and "pertain[s] to" the assessment and admin-

transfer pricing practices is previous IRS transfer pricing audits and cases. The problem of access to tax information could be alleviated were the IRS to join the RICO suit in order to recover lost taxes, a prospect which would seem likely given allegations of massive tax fraud.[76]

Circumstantial evidence is often as compelling as direct evidence. In the tax evasion scenario posited here, expert testimony could establish the causal link between racketeering and damages sustained by an American competitor of a *keiretsu*, in much the same way as is done in dumping cases.[77] Such things as reduced profits and loss of market share are relevant. For example, economist Prestowitz determined that United States car makers operate with a cost disadvantage of two thousand dollars per car as compared with the Japanese auto industry.[78] If this cost differential is partly the product of tax evasion, then this evidence would support RICO's damage causation element. A reasonable hypothesis is that loss of price advantage produced a decline in market position.

Chronology, the relation of things in time, is especially important. If goods or services were sold to a foreign-controlled United States based corporation at a transfer price determined only at fiscal year-end, then the inference would be that taxes, not economics, determined that price.

X. Injunction, Risks, and Political Blindsiding

An injunction may be used to secure an immediate cessation of transfer pricing abuses. An injunction is a front-loaded strategy intended to produce real market results at the outset and to protect American competitors from further loss during the pendency of the case. If the evidence shows a likelihood of prevailing and a threat of irreparable harm, then a

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istration of income taxes. This is especially so since a judgment could have a preclusive effect through collateral estoppel with respect to the issue of tax evasion, thus giving IRS a direct stake in the outcome of the case. *See United States v. Mendoza*, 464 U.S. 154, 158 (1984); *Allen v. McCurry*, 449 U.S. 90, 94-95 (1980) (offensive collateral estoppel).

76. One court has held that the government has no right of action for treble damages under RICO. United States v. The Bonano Organized Crime Family, 839 F.2d 20 (2d Cir. 1989). The government's participation may be based on a theory other than RICO.

77. Dumping cases are handled by the International Trade Administration of the United States Department of Commerce and the International Trade Commission. In a bifurcated process, a determination is made whether an import is being sold below fair market value, such that United States industry is injured or threatened with injury. *See* 19 U.S.C.A. § 1673(a)-(g) (West 1980 & Supp. 1991); 19 C.F.R. §§ 201, 207 (1990). The result is the imposition of antidumping duties on imported goods, not the damages to injured United States companies that RICO might provide.

78. Prestowitz, *supra* note 31, at 3.

federal court could enjoin[79] the Japanese company and its United States counterpart from setting artificially high transfer prices. This would have the significant advantage of testing the theories upon which the case is premised, producing an early result for an American competitor, and sending an unequivocal message to corporate Japan.

All litigation has risk. The use of RICO in the *keiretsu* setting is novel, and a court could impose monetary sanctions against the plaintiff, but only if the legal theory is found by the court to be frivolous and unsupported by the facts.[80] The best defense to sanctions is a complaint thoroughly grounded on solid investigation. The litigation would be massive and likely to provoke a full retaliatory response, including counterclaims, because of what is at stake. If an injunction were granted, a court might order a bond to be posted.[81] The need for a bond is questionable, however, given that an injunction would only direct that transfer prices have an economic, not tax, justification. Japan Inc. would be hard pressed to claim the need for a bond, when the injunction merely ordered it not to evade taxes.

Litigation would occur in a highly charged political context. Japan Inc., using its considerable lobbying resources in Washington,[82] is likely to pressure the Department of Justice and the IRS not to cooperate with the suit or actively interfere with its progress. The Department of State would be likely to object to a RICO suit as interference with foreign policy objectives. Free trade advocates who would view this as a diplomatic rather than a business problem would also likely attempt to prevail. If successful, their efforts would be evident in the absence of overt government cooperation with any RICO action.

The free trade advocates make the faulty assumption that corporate Japan is a trading partner. It is not. Trade implies reciprocity and give-

79. Opinion apparently diverges on whether injunctive relief is available under RICO or through a federal court's general equitable powers. *Compare* Aetna Casualty & Sur. Co. v. Liebowitz, 570 F. Supp. 908 (E.D.N.Y. 1983) (equitable power), *aff'd on other grounds*, 730 F.2d 905 (2d Cir. 1984) and In re Fredeman Litigation, 843 F.2d 821 (5th Cir. 1988) (RICO statutory authority) *with* Religious Technology Center v. Wollersheim, 796 F.2d 1076, 1080-89 (9th Cir. 1986), *cert. denied*, 479 U.S. 1103 (1987) (holding that RICO's legislative intent does not permit the granting of equitable relief). Federal courts also retain the power to enjoin the commission of a crime. In re Debs, 158 U.S. 564, 593 (1895).

80. Fed. R. Civ. P. 11.

81. *See, e.g.*, Fed. R. Civ. P. 65(c); Ferguson v. Tabah, 288 F.2d 665, 675 (2d Cir. 1961).

82. *See* Pat Choate, Agents of Influence, chs. 4, 5 (1990); John B. Judis, *The Japanese Megaphone*, The New Republic, Jan. 22, 1990, at 20, 22.

and-take, concepts that trade deficit figures show are nearly absent in United States-Japan business. Responding to predatory practices with the concept of free trade is like regarding freedom as an adequate response to aggression. If government chooses not to intervene, then it should allow the private sector to present its best case. This requires some form of cooperation.

Because of political overtones, the choice of venue may be as critical as would be the choice of courts.[83] State courts have concurrent jurisdiction over civil RICO cases, which means that such cases may be brought in state, as well as in federal court.[84] Many states have their own civil RICO statutes.[85] The state court option should not be overlooked since local courts and juries would probably be more responsive to localized economic conditions and less concerned with international politics.

XI. The Color Television Cases

Any RICO action must take into account the political context in which it would occur. Prior experience shows that Japan Inc. has no reservation about using political clout when its interests are threatened by litigation. In the early 1980s American television manufacturers led by Zenith unsuccessfully used the antitrust laws to try to block what they saw as a conspiracy by Japanese firms to drive them out of business. Allegedly, the Japanese did this by selling television sets in Japan at artificially high prices and then using the profits to finance the sale of televisions at artificially low prices in the United States. In its brief to the United States Supreme Court in the antitrust case, the Japanese government admitted imposing controls on the exportation of Japanese goods, which the American TV industry alleged were unlawful.[86] The Justice Department intervened and actually supported the Japanese position that its companies merely observed Japanese government regulations limiting the price, quantity, and other conditions of export from Japan to foreign markets. This is known as the "foreign sovereign compulsion defense." The Justice Department found that there was "no evidence of concerted predatory conduct intended to destroy and supplant

83. A RICO action may be brought in any district in which a defendant "resides, is found, has an agent, or transacts his affairs." 18 U.S.C.A. § 1965(a).

84. Tafflin v. Levitt, 493 U.S. 455 (1990).

85. New Jersey, Ohio, Indiana, Washington, and Illinois are among those states with their own civil RICO statutes. Blakey & Perry, *supra* note 56, at 988-1011 (detailing in chart form federal and state RICO legislation).

86. Brief of the Gov't of Japan at 3, Matsushita Electric Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986), *available in* LEXIS, Genfed library, Briefs File.

the [United States] color TV industry," and that the "simple economic illogic" of such a plan disproved its existence.[87]

The Supreme Court, in a five to four vote, accepted the Justice Department's "economic illogic" theory,[88] but not before hearing the position of the government of Japan in a related dumping case.[89] The Court did not decide the "foreign sovereign compulsion defense" issue. In the related dumping case, the United States Solicitor General presented to the Court, at the request of the State Department, a letter that originated from the Japanese government. The letter warned that a decision against Japan's interests would damage United States-Japan trade and "adversely affect world trade generally."[90] The submission of this letter was so far out of line that Justice Blackmun asked the Solicitor General whether the letter was "a threat to this Court" and whether he was doing his "best to uphold the position espoused by the government of Japan."[91]

In retrospect, the Justice Department position supporting Japan Inc. would be merely quaint and dated, were it not for the resulting destruction of the American color television industry. Zenith remains the only major United States based firm producing color televisions, maintaining only one television and one picture tube plant in the nation.[92] The bulk of Zenith's television manufacturing now occurs in Mexico.[93]

The high-powered lobbying apparent in the television cases may be in the process of being repeated. United States Customs Service auditors reportedly have concluded that Honda owed about 20 million dollars in tariffs on 1989 and 1990 model cars imported into the United States from Canada.[94] Although these cars could be imported duty-free provided that at least half of the value added to them originated in North

87. Brief for the United States at 18, Matsushita Electric Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986), *available in* LEXIS, Genfed library, Briefs File.

88. Matsushita Electric Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986).

89. Zenith Radio Corp. v. United States, 437 U.S. 443 (1978).

90. CHOATE, *supra* note 82, at 93.

91. *Id.* at 93-94. In the related dumping case, United States television manufacturers also lost by unanimous vote in their attempt to force the Department of Treasury to collect 382 million dollars in assessed, but uncollected, duties on imported color televisions. Presumably after much lobbying, Japanese companies paid only 16 million dollars. *Id.* at 97.

92. GRAHAM & KRUGMAN, *supra* note 29, at 52-53.

93. *Id.*

94. The United States Customs Service denied the author's Freedom of Information Act request for the Honda audit report and a memorandum of the Customs Commissioner approving their findings. Although the author appealed the decision, the United States Customs Service affirmed its original decision on February 4, 1992.

America, customs auditors concluded the actual North American content was only forty percent. The Customs Commissioner originally decided to initiate collection action on the tariff, then concluded that the matter needed further investigation after a visit from Honda's attorney, a former Treasury Department general counsel,[95] then finally upheld the initial findings of Customs auditors.[96] Japan's minister of International Trade and Industry characterized Custom's action as "discrimination against a Japanese company."[97] Honda has announced its intention to appeal.

RICO could neutralize Japan Inc.'s political operatives. Given the RICO statute's purposefully broad scope, it appears unlikely that the foreign sovereign compulsion defense could defeat a RICO action premised on tax evasion. The counterargument is simple; the direction of a foreign government is no defense to tax evasion.[98]

XII. Conclusion

Evidence of tax-dodging by Japanese controlled corporations through transfer pricing techniques is compelling. Billions in tax revenues have been lost. American business has also paid a price. All that is left to do is a case-by-case analysis to fix individual responsibility. RICO's "well-aimed light" should be able to do that.

Someone else will argue later—it is sure to be an American lawyer—that what I propose is no solution at all, and nothing more than a lawyer's proscription for high-intensity conflict. To the contrary, this is a battle that should be fought to begin to change the order of things. Even

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95. Paul Magnusson et al., *Honda Is It An American Car?*, Bus. Wk., Nov. 18, 1991, at 108.

96. Robert Pear, *Duties Set on Honda Over Parts*, N.Y. Times, Mar. 3, 1992, at D1.

97. *U.S. Move on Honda Triggers Complaints by Japanese Official*, Wall St. J., Mar. 4, 1992, at 6.

98. In a true assertion of the foreign sovereign compulsion defense, a defendant admits its own conduct has been unlawful, but argues that dismissal is warranted because a foreign government compelled the unlawful conduct. *See* Mannington Mills, Inc. v. Congoleum Corp., 595 F.2d 1287, 1293 (3rd Cir. 1979); Interamerican Ref. Corp. v. Texaco Maracaibo, 307 F. Supp. 1292, 1297-98 (D. Del. 1970). Essentially, courts are asked to abstain from exercising jurisdiction, a dubious prospect for private litigants in light of recent Supreme Court decisions. W.S. Kilpatrick & Co., Inc. v. Environmental Tectonics Corp., 493 U.S. 400 (1990) (Act of state doctrine did not bar RICO action predicated upon the payment of bribes to a foreign official to secure the award of a foreign government contract); New Orleans Pub. Serv. v. New Orleans, 491 U.S. 350, 358 (1989) ("federal courts lack the authority to abstain from the exercise of jurisdiction that has been conferred").

they are to become more open to competition.[105] RICO could certainly do that.

United States business seems ever the compliant victim. Whether it be corporate Japan or unscrupulous junk bond promoters and takeover artists, or government regulation (too much or too little), someone else always seems to be to blame for business setbacks. Because the root of the problem lies elsewhere, so it seems to American business does the solution.

Yet, RICO is available now for those with the will to act. As they think about it, market share continues to shrink and RICO's four year statute of limitations ticks away.

105. Yamamura, *supra* note 10, at 51.

STATEMENT OF
FRANCES ZUNIGA

BEFORE THE

SENATE GOVERNMENT AFFAIRS COMMITTEE
U.S. SENATE

March 25, 1993

Mr. Chairman, and members of the committee:

My name is Frances Zuniga. Please accept my thanks for the privilege of submitting my written testimony. I would like to share my experience with IRC Section 482 pricing cases with you.

I am now employed in private industry. Before I joined private industry, I was employed by the State of California Franchise Tax Board (FTB) from 1989 to 1991. At FTB I trained the auditors on certain aspects of the State of California's Water's Edge legislation. This training included a study of Section 482 of the Internal Revenue Code and its regulations, and instruction to the auditors of how to examine intercompany transactions between their taxpayers and related companies not included in a state combined report due to a Water's Edge election.

Before I started with the FTB, I was a revenue agent with the Internal Revenue Service (IRS) for almost fifteen years. Six of those years I was an international examiner (I.E.). As an I.E., I examined foreign owned distributors of consumer products as well as U.S. based corporations and their controlled foreign corporations. While with the IRS, I proposed adjustments and issued International

Examiner's reports based on several international issues, including Subpart F issues and IRC Section 482 issues. These reports became the basis for both 30 and 90 day letters issued to taxpayers under my examination. While with the IRS I also prepared training materials and taught classes specifically on Section 482 issues and related examination guidelines.

The purpose of this statement is to impress upon you my deep concern over the ability of the IRS to administer the enforcement of Section 482. As I stated in testimony before another Congressional committee in 1990, the heart of the problem is Section 482 and the regulations, and it is still my belief even though there are new proposed regulations.

The purpose of Section 482 is to prevent the evasion or avoidance of tax by taxpayers engaged in transactions with related parties. The intended result is to place a controlled taxpayer on the same parity as an uncontrolled party with respect to those transactions. The standard to be used is known as the arm's length standard. In most cases this standard is derived at indirectly by an IRS economist utilizing a subjective hypothesis, because normally the companies and their affiliates have no unrelated third party transactions with which to measure the related ones. This hypothesis is formed based upon critical assumptions that the IRS economist has made concerning the business of the taxpayer.

The logical starting point is to identify other companies in the same industry as the taxpayer and attempt somehow to make them comparable to the taxpayer. However, if other companies in the industry are not comparable (usually because they also engage primarily in controlled party transactions), the economist is left with the dilemma of searching the universe for the arm's length transaction which is closest to the taxpayer's transactions. Literally that economist must go from soup to nuts in his search for anything which resembles a comparable.

The fact is no one can really determine an arm's length price. There are simply no comparable transactions for many of these companies. The arm's length standard pretends that related companies behave as if they are unrelated and assumes that in each marketplace there are willing buyers and sellers. This assumption clearly does not work where the market is controlled.

Under these circumstances the IRS is left with the untrammeled discretion of using "any reasonable" method to determine the so called arm's length price. Such a method is at the very least subjective and inaccurate and can yield very unnatural results.

Many times the results obtained using such inexact comparables confers more income to the taxpayer than the combined incomes of both the taxpayer and its affiliate. There is something inherently wrong with this conclusion. Consequently a result such as this

ignores the economic reality of the companies as a single economic unit, and leaves no room for recognition of the realities of the relationship. My experience is that the I.E. or his manager will decide to use the comparable which yields the highest adjustment, not necessarily the correct adjustment.

Unfortunately, the scenario becomes predictable. The company and its attorneys take one extreme position, the IRS the other, each side hoping that their positions will gain the advantage. This results in a very costly process for both sides. This forces reliance on a hypothetical standard which, only by definition, is reasonable based only on itself and not the actual facts and circumstances.

Another problem with the selection of such a "comparable" is that once the IRS comes up with what it believes to be a pricing methodology, it will want to use that particular methodology for future examination years, despite significant changes in the particular industry or economy.

I.E.s and economists have little or no resources to perform acceptable research on what comparables, if any, are available to review. If there are companies that might appear comparable, the I.E. is stopped by his own management from adequately evaluating the data from them and is not supported with the summons enforcement process. Because the potentially comparable companies

are not the taxpayer under examination, it is very difficult to motivate them to turn over information, much less supporting documentation. One reason for this is much of the information sought from potential comparable companies is proprietary in nature, and not the type of data a company would be willing to share with its competition. It is the policy of the IRS for I.E.s not to issue summonses to third parties, even when such summonses are considered "friendly". Therefore the I.E. is left with making a determination based on publicly available information not specific enough to make a valid assessment of the comparability of the underlying risks and functions.

From an I.E.'s and his manager's points of view, pricing cases are not desirable because they cannot be closed quickly. Pricing audits take a very long time because of the amount of facts needed to be developed. Pricing cases do not lend themselves easily to a digestible audit program. If a case takes a long time to work, an I.E. is under serious pressure from his case manager or branch chief to raise a significant issue. The longer the case takes to work, the higher the expected adjustment is in order to justify the time spent on the examination, whether that adjustment is correct or not. Left to his own imagination, the I.E. tends to "cherrypick" from the information the facts that best support the highest possible adjustment. Predictably, this leads to a very expensive "war" between the taxpayer and the IRS, with much of the fight focusing over what facts were important.

Because of this tendency taxpayers and their representatives are not motivated to cooperate with the I.E. The goal of most taxpayers undergoing an examination by the IRS is to resolve issues as quickly and as efficiently as possible. A pricing examination tends to be so complex and time consuming that taxpayers find many I.E.'s and their managers unable or unwilling to seriously explore resolution of the issue at the examination level, contrary to the goals set by Compliance 2000. Taxpayers are hesitant to expend the cost and effort to cooperate when much of the information required by the I.E. ends up not being considered.

The IRS Internal Revenue Manual has a fairly detailed audit plan for the I.E. with respect to Section 482 issues. The Manual calls for the gathering of voluminous information and the production of a functional analysis, but does not really assist the I.E. with what to do with information once gathered or the analysis once performed, nor is the I.E. able to give the taxpayer an adequate explanation of why the information must be gathered.

After all the time and effort spent by both the IRS and the taxpayer to get information, the data is not really that useful for determining a potential adjustment. With all the emphasis and effort which went into the Section 6038A legislation, the ultimate value of the information is questionable, because it usually will not identify comparable transactions on which to develop a pricing methodology.

A Section 482 examination requires a lot of manpower and other resources; a team of I.E.s, an economist, and an attorney, not to mention clerks and accounting aides. The examinations are difficult for the I.E., because even with the added legislation empowering the I.E. to require foreign based information from the taxpayer, his or her management fails to lend timely support. My experience in my last years with the IRS was that the priority for IRS managers was case statistics in terms of dollar adjustments raised per hour of examination time.

When I was first assigned my pricing cases, they already had been in process for over three years. The I.E. previously assigned to the case had taken advantage of a district reorganization to leave the cases, but not before he wrote a report which applied an incorrect adjustment. I brought the report to the attention of my manager and branch chief. My assessment was to either start over or withdraw from the case with a no-change recommendation. However, I was ordered by my branch chief through the case manager to use the report anyway. I refused and while I was away on a teaching detail, the branch chief directed my manager and the case manager to meet secretly with the president of one of the companies in an effort to coerce the company to accept an adjustment that had no basis in law. When I returned from my teaching detail I was required to present the taxpayer with an adjustment calculated using the prior I.E.'s methodology. Feeling that there was nothing else I could do, I complied with my orders.

This kind of pressure on an I.E. to produce adjustments by management guarantees a tax policy which lacks integrity, does nothing to motivate voluntary compliance and destroys employee morale. One of the major reasons I decided to leave the IRS was because I could not reconcile myself to produce adjustments on issues which I did not believe in.

In 1990 I had the honor of presenting my testimony before the Subcommittee on Oversight concerning this issue. I stated in prior testimony that I believed in the tax system. I still do. I understood that tax law is not always "fair" to all taxpayers all the time. However, I do believe that in order to encourage voluntary compliance, tax laws have to be administered evenly and consistently all the time, and this just does not occur with the administration of Section 482.

My belief is that it is time for the myth of the arm's length standard to be laid to rest. Chasing the holy grail of the arm's length standard is not constructive to either the IRS or the taxpayer. The only real beneficiaries from sustaining this philosophy are tax attorneys and self styled expert witnesses.

This issue is costing both sides incredible amounts of time and money and is worse than the tax shelter cases were in bottling up Tax Court. At least a resolution in a tax shelter case could be applied to a number of cases with similar issues. However, pricing

cases are so fact sensitive that even after all the time and effort and cost there is little learned which is useful to any other taxpayer.

I believe the IRS needs to direct its efforts back to voluntary compliance from its taxpayers and I applaud Compliance 2000. There are other challenges before the IRS which I believe are much more important and deserving of its enforcement efforts than expending its I.E.s and other scarce resources like so much cannon fodder on a battle that should just not happen.

Section 482 is a simple statute subject to almost twenty five years of complex interpretation. Uncertainty and dissatisfaction with the regulations in existence for almost three decades have resulted in change after change. Still with all the time and effort made to produce the proposed regulations, we are no better off than we were twenty five years ago. This fact alone should demonstrate the complexity of the issues involved.

I find myself wondering whether we are trying to hold on to an ideology which, while admirable in theory, is just not practical to administer. A methodology of determining a taxing jurisdiction's fair share of tax from an enterprise can certainly be agreed to in some form of a profit split, or a formulary approach. While by no means the only answer, such a method must be preferable because it can be reasonably administered. A profit split, or other formulary approach, recognizes economic unit as a whole. While reasonable people may disagree what formula should be employed, at least there is a basis of reference. By definition limits are set and I.E.s can arrive at a reasonable conclusion without expending years and valuable resources on such a controversial issue.

United States General Accounting Office

GAO

Fact Sheet for the Honorable
Byron L. Dorgan, U.S. Senate

June 1993

INTERNATIONAL TAXATION

Taxes of Foreign- and U.S.-Controlled Corporations

GAO/GGD-93-112FS

GAO United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-253439

June 11, 1993

The Honorable Byron L. Dorgan
United States Senate

Dear Senator Dorgan:

This fact sheet responds to your request for additional information on corporations that paid little taxes. Specifically, we determined how many taxpaying corporations in various asset categories paid a minimal amount of income tax in 1989. In addition, we identified the specific line items on the tax return that accounted for the differences in the cost of goods sold reported by foreign- and U.S.-controlled corporations. This information is presented in the attached tables and summarized below.

MANY VERY LARGE CORPORATIONS PAID LESS THAN $100,000 IN INCOME TAX

More than 40 percent of very large corporations doing business in the United States--those with assets of $250 million or more--either paid no income taxes or paid income taxes of less than $100,000.[1] In our recent testimony on transfer pricing issues, we reported that 207 (30 percent) of the 693 very large foreign-controlled corporations did not pay income taxes, as compared to 1,555 (33 percent) of the 4,650 very large U.S.-controlled corporations.[2] In the group of very large taxpaying corporations, we found that 102 (15 percent) foreign-

[1]We use $100,000 as our cutoff for minimal taxes paid here because the corporations of this size that did pay taxes paid an average of $19 million, and compared to that figure, we believe $100,000 is a relatively small amount. Similar reasoning lies behind the other minimal amounts we use although the gaps between average and minimal taxes are not nearly as large.

[2]International Taxation: Updated Information on Transfer Pricing (GAO/T-GGD-93-16, Mar. 25, 1993).

controlled corporations and 362 (8 percent) U.S.-controlled corporations paid less than $100,000 in income taxes (see table I.1 in appendix I). Combined, the corporations either paying no taxes or minimal taxes were about 45 percent of all very large foreign-controlled corporations and about 41 percent of all very large U.S.-controlled corporations. These corporations had about 27 and 11 percent, respectively, of the total receipts of all very large corporations (see table I.2) and owned about 36 and 19 percent, respectively, of the total assets owned by all very large corporations (see table I.3).

FEWER VERY LARGE FOREIGN-CONTROLLED CORPORATIONS PAID INCOME TAXES OF $1 MILLION OR MORE, BUT THEY ALSO ACCOUNTED FOR FEWER RECEIPTS

Proportionately, fewer very large foreign-controlled corporations than their U.S. counterparts paid income taxes of $1 million or more (see table I.1). About 36 percent of very large foreign-controlled corporations paid income taxes of $1 million or more, compared with 47 percent of very large U.S.-controlled corporations. However, these very large foreign-controlled corporations also accounted for fewer receipts. Table I.2 shows that these corporations accounted for 61 percent of the total receipts of very large foreign-controlled corporations, compared with 85 percent of the total receipts of very large U.S.-controlled corporations.

Taxes paid by this group of very large corporations--those that paid $1 million or more in taxes--averaged $16.7 million ($4,127.5 million divided by 247 corporations) among those foreign-controlled and $29.5 million ($64,141.3 million divided by 2,172 corporations) for those U.S.-controlled.

PROPORTIONATELY, SMALLER FOREIGN-CONTROLLED CORPORATIONS ACCOUNTED FOR MORE TAXES PAID

The pattern changes among corporations with less than $100 million in assets. In this group, 88 percent of foreign-controlled and 93 percent of U.S.-controlled corporations paid either no income tax or less than $10,000 in taxes. These corporations accounted for 49 percent and 56 percent of total receipts, respectively.

In addition, more foreign-controlled corporations of this size paid $1 million or more in income taxes--0.7 percent compared to 0.1 percent for U.S.-controlled corporations of this size. These foreign-controlled corporations accounted for 13 percent of the receipts of foreign-controlled corporations of this size, compared to 7 percent of receipts of U.S. controlled corporations in this group.

Tables I.3 and I.4 provide additional information on the assets owned and taxes paid by foreign- and U.S.-controlled corporations with assets of $100 million or more. Tables I.5 through I.8 show returns, receipts, assets owned, and taxes paid by corporations with assets of less than $100 million.

THE COST OF PURCHASES COMPRISES A LARGER PERCENTAGE OF TOTAL RECEIPTS FOR FOREIGN-CONTROLLED CORPORATIONS

We found in our 1992 transfer pricing report[3] that the ratio of cost of goods sold over sales for foreign-controlled corporations was 75 percent in 1987, which was 10 percent higher than the same ratio for U.S.-controlled corporations. Also, the ratio of cost of goods sold over sales for a group of Japanese-controlled firms in five wholesale industries was consistently higher than the same ratio for both European- and U.S.-controlled wholesale firms between 1983 and 1987.[4]

In our 1993 transfer pricing testimony, we reported that the ratios of cost of goods sold to receipts for all taxpaying and nontaxpaying foreign-controlled corporations were 12 and 14.7 percentage points higher, respectively, than the ratios for U.S.-controlled corporations of the same taxpaying status in 1989. Some have speculated that artificially high intercompany prices caused higher percentages like these on the part of foreign-controlled corporations.

Tables I.9 and I.10 present the various components that make up cost of goods sold. The largest component of cost of goods sold for both foreign- and U.S.-controlled corporations is purchases. However, the ratio of purchases to total receipts for foreign-controlled corporations was much greater than the ratio for U.S.-controlled corporations. Taxpaying foreign-controlled corporations had a ratio of nearly 54 percent, 20 percentage points higher than that for taxpaying U.S.-controlled corporations. For corporations that did not pay tax, the ratio of purchases to receipts was about 17 percentage points higher for foreign-controlled corporations than for U.S.-controlled corporations.

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[3]International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (GAO/GGD-92-89), June 15, 1992).

[4]The five wholesale industries were machinery, equipment, and supplies; motor vehicles and automotive equipment; metals and minerals; electrical goods; and other durable goods. These industries accounted for 29 percent of all foreign-controlled corporations' sales in 1987 but only 4 percent of all U.S.-controlled corporations' sales.

B-253439

METHODOLOGY

To obtain the information for this fact sheet, we analyzed 1989 data from the Internal Revenue Service's (IRS) Statistics of Income (SOI) Division. The database includes a weighted sample of both U.S.- and foreign-controlled corporate tax returns filed in the United States. In general, SOI included in its 1989 database almost all large firms with assets of $100 million or more. Hence, the estimates in tables I.1 to I.4 for large firms with assets of $100 million or more would have little sampling error.

However, the estimates in tables I.5 to I.10 are based on samples, and hence they are subject to sampling error. Differences between U.S.-controlled and foreign-controlled corporations in the tables I.5 to 1.10 may not be statistically significant. Data limitations are discussed in the SOI publication 1989 Corporation Income Tax Returns.

We did our work between March and May 1993 in accordance with generally accepted government auditing standards.

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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this fact sheet until 30 days from the date of this letter. At that time, we will send copies to the Commissioner of the Internal Revenue Service, the Secretary of the Treasury, and other interested parties. The major contributors to this fact sheet are listed in appendix II. If you have any questions about the information provided, please contact me at (202) 272-7904.

Sincerely yours,

Natwar M. Gandhi
Associate Director, Tax Policy and
Administration Issues

STATISTICS ON FOREIGN- AND U.S.-CONTROLLED CORPORATIONS

Table I.1: Number of Returns of Foreign- and U.S.-Controlled Corporations With $100 Million or More in Assets, by Income Taxes Paid, 1989

Distribution by asset size/taxes paid	Foreign-controlled corporations		U.S.-controlled corporations	
Companies with assets of $250 million or more	Number of returns	Percent of asset group	Number of returns	Percent of asset group
No tax paid	207	29.9	1,555	33.4
Less than $100,000	102	14.7	362	7.8
$100,000 under $1 million	137	19.8	561	12.1
$1 million or more	247	35.6	2,172	46.7
Total	693	100.0	4,650	100.0
Companies with assets of $100 million or more but less than $250 million				
No tax paid	238	39.4	1,614	34.0
Less than $100,000	88	14.6	467	9.8
$100,000 under $1 million	158	26.3	1,717	36.1
$1 million or more	119	19.8	954	20.1
Total	603	100.00	4,752	100.0

Note: Totals may not add due to rounding.

Source: IRS.

Table I.2: Receipts of Foreign- and U.S.-Controlled Corporations With $100 Million or More in Assets, by Income Taxes Paid, 1989

Dollars in millions

Distribution by asset size/taxes paid	Foreign-controlled corporations		U.S.-controlled corporations	
Companies with assets of $250 million or more	Receipts	Percent of asset group	Receipts	Percent of asset group
No tax paid	$94,956	14.0	$341,620	6.8
Less than $100,000	87,037	12.8	202,996	4.0
$100,000 under $1 million	80,056	11.8	213,939	4.2
$1 million or more	417,236	61.4	4,288,515	85.0
Total	$679,285	100.0	$5,047,070	100.0
Companies with assets of $100 million or more but less than $250 million				
No tax paid	$30,450	31.4	$85,101	20.3
Less than $100,000	14,354	14.8	41,030	9.8
$100,000 under $1 million	26,934	27.7	87,258	20.8
$1 million or more	25,365	26.1	206,756	49.2
Total	$97,103	100.0	$420,145	100.0

Note: Totals may not add due to rounding.

Source: IRS.

Table 1.3: Assets of Foreign- and U.S.-Controlled Corporations With $100 Million or More in Assets, by Income Taxes Paid, 1989

Dollars in millions

Distribution by asset size/taxes paid	Foreign-controlled corporations		U.S.-controlled corporations	
Companies with assets of $250 million or more	Assets	Percent of asset group	Assets	Percent of asset group
No tax paid	$243,226	20.6	$1,904,803	14.9
Less than $100,000	176,543	15.0	525,914	4.1
$100,000 under $1 million	128,083	10.9	521,319	4.1
$1 million or more	631,022	53.5	9,844,794	76.9
Total	$1,178,874	100.0	$12,796,830	100.0
Companies with assets of $100 million or more but less than $250 million				
No tax paid	$36,530	38.7	$252,339	34.1
Less than $100,000	13,471	14.3	71,832	9.7
$100,000 under $1 million	25,041	26.5	259,779	35.1
$1 million or more	19,357	20.5	155,538	21.0
Total	$94,399	100.0	$739,488	100.0

Note: Totals may not add due to rounding.

Source: IRS.

Table I.4: Taxes Paid by Foreign- and U.S.-Controlled Corporations With $100 Million or More in Assets, by Income Taxes Paid, 1989

Dollars in millions

Distribution by asset size/ taxes paid	Foreign-controlled corporations		U.S.-controlled corporations	
Companies with assets of $250 million or more	Taxes paid	Percent of asset group	Taxes paid	Percent of asset group
No tax paid	$0.0	0.0	$0.0	0.0
Less than $100,000	2.6	0.1	9.3	0.0
$100,000 under $1 million	63.4	1.5	283.2	0.4
$1 million or more	4,127.5	98.4	64,141.3	99.6
Total	$4,193.5	100.0	$64,433.8	100.0
Companies with assets of $100 million or more but less than $250 million				
No tax paid	$0.0	0.0	$0.0	0.0
Less than $100,000	2.5	0.5	15.6	0.3
$100,000 under $1 million	60.8	11.5	768.4	15.2
$1 million or more	466.9	88.1	4,264.2	84.5
Total	$530.2	100.0	$5,048.2	100.0

Note: Totals may not add due to rounding.

Source: IRS.

Table I.5: Number of Returns of Foreign- and U.S.-Controlled Corporations With Less Than $100 Million in Assets, by Income Taxes Paid, 1989

	Foreign-controlled corporations		U.S.-controlled corporations	
Distribution by taxes paid of companies with assets of less than $100 million	Number of returns	Percent of asset group	Number of returns	Percent of asset group
No tax paid	31,690	72.8	1,262,801	59.0
Less than $10,000	6,792	15.6	721,269	33.7
$10,000 under $100,000	3,039	7.0	124,646	5.8
$100,000 under $1 million	1,719	4.0	29,126	1.4
$1 million or more	303	0.7	2,381	0.1
Total	43,543	100.0	2,140,223	100.0

Note 1: Totals may not add due to rounding.

Note 2: Figures were obtained from weighted estimates based on samples. The weights were provided by IRS, and the estimates are subject to sampling error. Sampling error may vary widely from one estimate to another. Data limitations are discussed in SOI publication, 1989 Corporation Income Tax Returns.

Source: IRS.

Table I.6: Receipts of Foreign- and U.S.-Controlled Corporations With Less Than $100 Million in Assets, by Income Taxes Paid, 1989

Dollars in millions

	Foreign-controlled corporations		U.S.-controlled corporations	
Distribution by taxes paid of companies with assets of less than $100 million	Receipts	Percent of asset group	Receipts	Percent of asset group
No tax paid	$77,553	40.7	$975,842	34.5
Less than $10,000	15,922	8.4	592,702	21.0
$10,000 under $100,000	30,505	16.0	543,540	19.2
$100,000 under $1 million	42,262	22.2	512,437	18.1
$1 million or more	24,491	12.8	203,736	7.2
Total	$190,733	100.0	$2,828,257	100.0

Note 1: Totals may not add due to rounding

Note 2: Figures were obtained from weighted estimates based on samples. The weights were provided by IRS, and the estimates are subject to sampling error. Sampling error may vary widely from one estimate to another. Data limitations are discussed in SOI publication, 1989 Corporation Income Tax Returns.

Source: IRS.

Table I.7: Assets of Foreign- and U.S.-Controlled Corporations With Less Than $100 Million in Assets, by Income Taxes Paid, 1989

Dollars in millions

	Foreign-controlled corporations		U.S.-controlled corporations	
Distribution by taxes paid of companies with assets of less than $100 million	Assets	Percent of asset group	Assets	Percent of asset group
No tax paid	$83,121	53.3	$674,634	38.7
Less than $10,000	12,824	8.2	252,476	14.5
$10,000 under $100,000	20,237	13.0	318,014	18.2
$100,000 under $1 million	28,111	18.0	406,749	23.3
$1 million or more	11,583	7.4	93,749	5.4
Total	$155,876	100.0	$1,745,622	100.0

Note 1: Totals may not add due to rounding.

Note 2: Figures were obtained from weighted estimates based on samples. The weights were provided by IRS, and the estimates are subject to sampling error. Sampling error may vary widely from one estimate to another. Data limitations are discussed in SOI publication, 1989 Corporation Income Tax Returns.

Source: IRS.

Table I.8: Taxes Paid by Foreign- and U.S.-Controlled Corporations With Less Than $100 Million in Assets, by Income Taxes Paid, 1989

Dollars in millions

	Foreign-controlled corporations		U.S.-controlled corporations	
Distribution by taxes paid of companies with assets of less than $100 million	Taxes paid	Percent of asset group	Taxes paid	Percent of asset group
No tax paid	$0.0	0.0	$0.0	0.0
Less than $10,000	13.9	1.0	1,584.9	8.6
$10,000 under $100,000	113.4	7.9	3,698.8	20.1
$100,000 under $1 million	553.7	38.5	7,465.8	40.5
$1 million or more	756.4	52.6	5,699.9	30.9
Total	$1,437.4	100.0	$18,449.4	100.0

Note 1: Totals may not add due to rounding.

Note 2: Figures were obtained from weighted estimates based on samples. The weights were provided by IRS, and the estimates are subject to sampling error. Sampling error may vary widely from one estimate to another. Data limitations are discussed in SOI publication, 1989 Corporation Income Tax Returns.

Source: IRS.

Table I.9: Individual Components of Cost of Goods Sold as a Percentage of Total Receipts, Corporations That Paid Income Tax, 1989

Dollars in millions

	Foreign-controlled corporations		U.S.-controlled corporations	
Tax return item	Dollars	Percent of total receipts	Dollars	Percent of total receipts
Inventory, beginning of year	$67,076	8.8	$438,345	6.4
Purchases	411,087	53.8	2,330,816	33.8
Cost of labor	24,742	3.2	331,336	4.8
Additional section 263A costs[a]	3,225	0.4	21,319	0.3
Other costs[b]	67,466	8.8	821,170	11.9
Inventory, end of year[c]	71,798	9.4	450,086	6.5
Total cost of goods sold[d]	$515,291	67.4	$3,819,244	55.4
Total receipts	$764,162		$6,892,907	

Note: Figures were obtained from weighted estimates based on samples. The weights were provided by IRS, and the estimates are subject to sampling error. Sampling error may vary widely from one estimate to another. Data limitations are discussed in SOI publication, 1989 Corporation Income Tax Returns.

[a]Section 263A costs are costs associated with items that must be capitalized under the uniform capitalization rules enacted by Congress in 1986.

[b]Other costs represent any costs paid or incurred during the tax year and not already included in the line items above it.

[c]End-of-year inventory is subtracted from the other components to arrive at the cost of goods sold.

[d]The total cost of goods sold figure does not equal the sum of its components because IRS uses the cost of goods sold figure reported by the taxpayer on the return, instead of computing it based on the components. IRS personnel told us that the discrepancy may be due to taxpayer errors and the failure of some taxpayers to submit the Schedule A, which breaks out the individual components.

Table I.10: Individual Components of Costs of Goods Sold as a Percentage of Total Receipts, Corporations That Did Not Pay Income Tax, 1989

Dollars in millions

	Foreign-controlled corporations		U.S.-controlled corporations	
Tax return item	Dollars	Percent of Total Receipts	Dollars	Percent of Total Receipts
Inventory, beginning of year	$24,631	12.1	$110,754	7.9
Purchases	108,391	53.4	515,787	36.8
Cost of labor	7,441	3.7	68,566	4.9
Additional section 263A costs[a]	911	0.5	4,018	0.3
Other costs[b]	25,629	12.6	168,131	12.0
Inventory, end of year[c]	25,794	12.7	107,286	7.7
Total cost of goods sold[d]	$141,952	69.9	$774,893	55.2
Total Receipts	$202,959		$1,402,563	

Note: Figures were obtained from weighted estimates based on samples. The weights were provided by IRS, and the estimates are subject to sampling error. Sampling error may vary widely from one estimate to another. Data limitations are discussed in SOI publication, 1989 Corporation Income Tax Returns.

[a]Section 263A costs are costs associated with items that must be capitalized under the uniform capitalization rules enacted by Congress in 1986.

[b]Other costs represent any costs paid or incurred during the tax year and not already included in the line items above it.

[c]End-of-year inventory is subtracted from the other components to arrive at the cost of goods sold.

[d]The total cost of goods sold figure does not equal the sum of its components because IRS uses the cost of goods sold figure reported by the taxpayer on the return, instead of computing it based on the components. IRS personnel told us that the discrepancy may be due to taxpayer errors and the failure of some taxpayers to submit the Schedule A, which breaks out the individual components.

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66-349 O - 93 (345)

ISBN 0-16-041126-2
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